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Business School

The Impact of "AAOIFI" Standards on the Financial Reporting of Islamic Banks: Evidence from Bahrain

A THESIS SUBMITTED FOR THE DEGREE OF THE DOCTOR OF PHILOSOPHY IN ACCOUNTING

Presented by

Mustafa. A. Abuhmaira

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Declaration

I herby declare that I am the author of this thesis, and that it has not previously been accepted for a higher degree.

Signed: ....

Mustafa Ali Abuhmaira

Date: ....

Signed: ....

Dr. Atsede Woldie

Signed: ....

Prof. Neil Marriott

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Abstract

The last 30 years have witnessed the appearance and rapid expansion of Islamic financial institutions operating both inside and outside the Islamic world. Islamic financial organisations are now operating in Western countries such as the UK, the US as well as most Islamic countries. The establishment of Islamic banks strengthens the need for Islamic accounting. Adopting or even modifying conventional accounting concepts, however, is insufficient to develop an accounting system which provides information that will lead to behaviour consistent with Islamic norms and objectives (Hameed, 2002).

The Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) was established in 1990 as an independent organisation to adjust the financial reports of Islamic organisations to comply with Islamic *Sharia'h* requirement. By 2005, AAOIFI's membership consisted of 93 institutions spanning over 23 countries. This organisation has introduced a new system of business accounting by issuing Islamic accounting standards. AAOIFI have now issued 50 standards on accounting, auditing, governance, ethical and *Sharia'h* standards (Alchaar 2005).

This study investigates and examines the extent of the application of the AAOIFI standards by Islamic banks in preparing their financial statements in Bahrain. Further, it explores whether the implementation of such standards provides relevant, reliable and sufficient information to the users of such information to assist them in decision-making. In addition, the awareness of the preparers of financial reports and progress in the quality of these financial reports has also been undertaken.

Finally the thesis draws appropriate conclusion and following a critical reflection and recommends areas for further research.

Glossary of Islamic Terms

Al-qard Alhassan:

Loan fixed for a definite period of time without interest or profit sharing.

***Al-masno'e*:**

The subject matter of the contract or the project in Istisna'a contract, which the bank is going to perform and sell to the other party of the contract of Istisna'a.

***Al-mustasne'e*:**

The ultimate purchaser or the party of Istisna'a contract who will receive Almasno'e.

***Al-sane'e*:** The seller or the party of contract who will produce the Almasno'e.

***Baitul mal*:**

An Islamic treasury intended for the community development as well as provision for needy Muslims.

***Ejtihad*:** Reasoning.

***Fatwa*:** Islamic legal opinion, or legal verdict given on a religious base.

***Fiqh*:** Islamic jurisprudence (science of *Sharia'h*). It is an important source of Islamic economics.

***Hades*:** what the prophet Mohammed (peace be upon him) says on a certain matter.

***Halal*:** Anything permitted by *Sharia'h.*

***Houl*:** One year, this refers to the lunar year.

Ibaha: Permissibility

***Ijarah*:** A contract under which the Islamic banks finance equipment, building or other facilities for the client against an agreed rental.

***Ijara Muntahia Bittamleek*:**

Ijara contract that leads to the transfer of ownership of leased assets to the lessee.

***Islam*:** Islam is a monotheistic religion. It is the last message or testament revealed by Allah (God) to all mankind. Mohammed has been sent to invite all mankind to guide them to believe in God and to perfect ethics and morals (being what previous messengers such as Muses and Jesus had called for).

Istisna'a (rental financing): A contract between a customer and a bank for construction/ manufacturing of a building or project by the Islamic bank. After completion, the Islamic bank hands over the building/ project to the customer who pays back his dues (the cost plus the bank's profit) according to an agreed schedule.

***Parallel Istisna'a*:**

If al-mustasne'e (the ultimate purchaser) does not stipulate in the contract that al-sane'e (the seller) should manufacture the al-masnoo'e by himself, then al-sane'e may enter into a second Istisna'a contract in order to fulfil his contractual obligations in the first contract. The second contract is called Parallel Istisna'a.

Mudaraba (trust financing):

The bank acts as a partner, providing cash to the borrower and sharing in the net profits and the net losses of the business. The loan is for an undetermined period, although the contract may be rescinded by either party.

***Khalifa*:** A religious head of a Muslim state.

***Mudarib*:** A speculator or a person who acts as an entrepreneur.

Murabaha (cost-plus trade financing):

The bank as a partner provides the finance for purchasing goods for a share of the profit once the goods are sold. The bank may or may not share any losses incurred. Repayment may be either in a lump sum or in instalments.

Musharaka (participating finance):

The bank provides part of the equity and part of the working capital for the business, and shares in profits and/or losses.

***Nisab*:** The amount that deemed appropriate for the payment of Zakat.

***Rab al-maal*:**

The owner of the capital.

***Riba*:** Usury/ interest which is strictly prohibited in Islam. Riba technically refers to the premium that must be paid without any consideration.

***Restricted investment accounts*:**

With this type of account, the investment accountholder imposes certain restrictions as to where, how and for what purpose his funds are to be invested. Furthermore, the Islamic bank may be restricted from commingling its own funds with the restricted investment account funds for purposes of investment.

***Qur'an*:** The Islamic holy book.

***Salam and parallel Salam*:**

Islamic forward sale.

Sharia'h: Islamic law, which embodies all aspects of Islamic faith including believes and practice.

Shura: Consultations and discussions before any decision is made.

Sunnah: After the Qur'an, Sunnah is the most important source of the Islamic faith and refers essentially to the prophet Mohammed (peace be upon him) as the supreme example through his practice of faith. The only way to know the Sunnah is through the collection of Hades.

Waqf: Endowment or property voluntarily transferred to a charity or trust so that it is used for public benefits.

Zakat: An Islamic tax imposed on the rich or having wealth above the prescribed minimum and given back mainly to the poor and needy.

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Chapter Four: The Islamic accounting standards setting agency and the Accounting and Auditing Organisation for Islamic Financial Institutions

Chapter Five: Research design and data collection

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Chapter One
Introduction

1 Introduction

Islamic banks are established with a mandate to adhere to Islamic *Sharia'h* rules and principles in all their transactions. However, the majority of Islamic banks perform both commercial and investment banking services and as supervisory authorities in countries which take various approaches to the regulation of Islamic banking. These include implementing Islamic Banking acts to regulate Islamic banks, subjecting Islamic banks to existing fiduciary laws, and regulating Islamic banks by the laws that govern all banks. Most of the countries in which these banks operate look directly to International Accounting Standards (IAS) as their national standards or develop national standards based primarily on IASs. This has meant that the users of financial statements of Islamic banks find them less reliable and have less confidence with the information they contain in making decisions (Karim, 2001).

Islamic banks have highlighted the need to develop and implement appropriate accounting standards, in order to present adequate, reliable and relevant information to the users of Islamic banks' annual reports. Consequently, Islamic banks have made significant progress towards achieving this objective. In 1990, the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) was established to prepare and promulgate accounting, (and recently) auditing and governance standards. By 2005 the AAOIFI have now issued 50 standards on accounting, auditing, governance, ethical and *Sharia'h* standards (Alchaar 2005).

However, there seems to be several factors that have contributed to the low implementation of AAOIFI's standards in the countries in which Islamic banks operate. These include, among others, the lack of appreciation by the relevant agencies that are responsible for enforcing accounting standards of the benefits that can be gained by implementing AAOIFI's standards. These benefits are: (a) rendering the financial statements of Islamic banks comparable and transparent; and (b) providing relevant and reliable information to users of financial statements of Islamic banks. This would require the AAOIFI to exert more effort in having its standards recognized by an increasing number of countries (Karim, 2001). In order to further its aim of constantly developing its supervision over the Islamic banks operating in Bahrain, and in order to implement a suitable accounting standards for these institutions, the Bahrain Monetary Agency (BMA) required all Islamic banks in Bahrain to issue their statutory accounts for the year ending on 31st December 1999, using the Islamic accounting standards adopted by the AAOIFI (BMA Annual Report, 1999).

Therefore, this study is an attempt to explore the role of AAOIFI standards in enabling Islamic banks to achieve their objectives in the society of Bahrain and to discover whether the use of AAOIFI standards adds additional information to the annual reports of Islamic banks and it also hopes to determine the extent of the usefulness of such information in decision-making. Furthermore, it hopes to understand how the preparers of financial statements perceive the application of the AAOIFI standards in presenting adequate and reliable financial statements.

This study also examines the satisfaction of the users' of financial reports of Islamic banks to discover the usefulness of these standards in forming financial reports to fit their needs.

Bahrain was chosen for the purpose of the study, because it was the first country in the Gulf Council Countries (GCC) to have the largest group of Islamic banks. Two thirds of Islamic banks operating in the GCC are located in Bahrain. Bahrain also hosts the AAOIFI that issues and supervises Islamic accounting standards and their application. Bahrain is regarded as the leading country for Islamic banking in the GCC; moreover, the implementation of AAOIFI standards became compulsory for Islamic banks from 1999.

2 Research problem

Studies conducted by AAOIFI revealed that the lack of approved standards to be followed by Islamic banks has a negative effect on the confidence of users of their financial statements and the information they contain. This is reflected in a negative attitude toward dealing with Islamic banks and hesitation in investing, depositing and exchanging services with them (AAOIFI, 2002).

The AAOIFI was established to set Islamic accounting standards which should be enforceable by all Islamic banks and other financial organisations, instead of applying modified accounting standards. This research seeks to explore whether applying AAOIFI standards adds any benefits to the financial information contained within the annual reports of Islamic banks in the State of Bahrain as one of the earliest countries which implemented these standards. Furthermore, the study examines whether applying AAOIFI standards increases users' confidence and trust in the content of the financial statements, helping them in their decision-making.

3 Research aims

The development of accounting standards specifically for Islamic banks is intended to achieve a number of aims, namely; to provide a uniform and consistent basis for preparing the financial statements of entities operating in the industry, to provide users with their needs of accounting information to assess business performance and investment risk, and to provide a clear view and understanding for the preparers of financial statements of Islamic financial organisations. Therefore, this research investigates the impact resulting from the application of the accounting standards issued by the AAOIFI on the financial reports of Islamic banks operating in the State of Bahrain. Specifically, the research aims to achieve the following objectives:

1. To investigate and explore the perception of those who prepare and use financial statements of Islamic banks in Bahrain with the kind of accounting standards and the regulation used in preparing these statements.
2. To investigate whether the implementing of the AAOIFI's standards in preparing the financial statements of Islamic banks is sufficient to provide users of such statements with the information they need.

3. To discover whether or not Islamic accounting regulations are welcomed amongst the users' of financial statements of Islamic banks and who should regulate them.
4. To state whether the recent annual reports of Islamic banks contain any additional information and examine the usefulness of such additional information to the users in assisting them in decision-making.
5. To explore whether the recent annual reports of Islamic banks have been prepared adequately in accordance to the AAOIFI standards and whether they fulfil the AAOIFI's requirements in particular.
6. To state whether the recent financial information in the financial statements of the Islamic banks are more relevant, more reliable and contain sufficient disclosure.

4 Research questions

The study sets out to answer the following questions:

1. How long have the users of financial reports of Islamic banks known and dealt with Islamic banks in the State of Bahrain?
2. Who should regulate Islamic accounting information and who should represent the process of accounting?
3. Which type of accounting standards are Islamic banks following in Bahrain?
4. Which types of accounting standards are more suitable for Islamic banking?
5. Do the users of financial reports of Islamic banks (internal and external) know about the existence of AAOIFI?

6. Which items are the most useful and are most commonly used when making a decision?
7. What items should be included in the annual report to enhance and improve the usefulness of financial information in decision-making?
8. Is there any additional information disclosed in the financial statements after applying AAOIFI standards?
9. What are the most important factors motivating individuals to deal with Islamic banks?

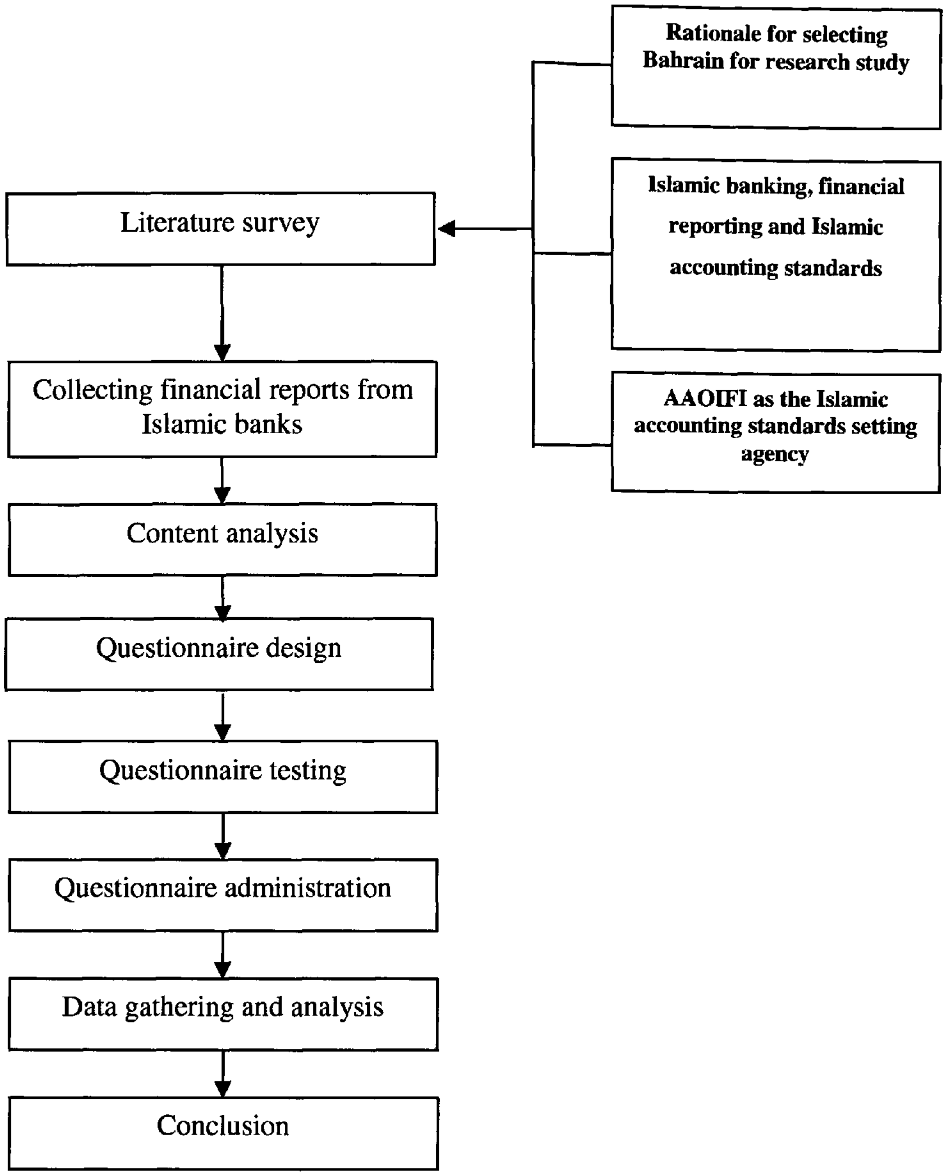
Instrumental in answering these questions is the analysis of the content of financial reports of Islamic banks and the surveying of the impressions of the users (internal & external) of such reports.

5 Research methodology

The primary objective of this section is to demonstrate how the study is to be conducted. In particular, it aims to outline the research methodology, strategy and techniques of collecting data (see the summary of the research methodology below in Figure 1.1). The study starts with illustrating the rationale behind choosing Bahrain for the purpose of the study, reviewing the literature of financial reports of Islamic banking, Islamic banking, Islamic accounting standards, their objectives, and the attitude towards conventional accounting standards. This will discover the need for the Islamisation of Islamic banking and argue the need for alternative accounting standards to fill the gap in this area. Discussing the organisation that might be suitable to issue, supervise and regulate accounting standard in a way appropriate to fit with *Sharia'h* law is inevitable. This study intends to employ two methods (content analysis and questionnaire survey) to investigate and answer the research questions.

This investigation is based on data found in the annual reports of Islamic banks in Bahrain and on how the users of such reports perceive their adequacy in the process of decision-making. Thus, this study will identify the benefits of applying AAOIFI standards in developing financial information of Islamic banks in order to satisfy the users' needs.

Figure 1.1: Research methodology



The respondents to be questioned in the study are; those employed in the Islamic banks in the State of Bahrain that have applied AAOIFI standards; those who are supervising the Islamic banks' operations such as the Bahrain Monetary Agency (BMA) and the General Council for Banks and Financial Islamic Organisations (GCBFIO); those who are auditing the financial reports of Islamic banks (Ernst &Young and Pricewaterhouse); those who are dealing with Islamic banks' shares in the stock market; and those who are interested in Islamic banks' activities such as academics and financial analysts. It is, therefore, the intent of this study to gain an understanding of the usefulness of the information contained the annual reports of Islamic banks to the users and to ascertain if the customer is satisfied by the reliability, the uniformity and the adequacy of financial reports. Finally, it is hoped that the study will help to clarify the AAOIFI contribution in improving the financial reports of Islamic banks.

6 Research limitations

Before delving into the limitations of this study, it is important to remember that the AAOIFI issues standards relating to financial institutions rather than other non-financial organisations such as companies who work in production, commerce, or services. The importance is that non-financial organisations are based on 'buy and sell' transactions. This kind of transaction is not based on monopolizing money to prevent another's who is in need of finance to satisfy their needs. On the other hand, Islam encourages individuals to work but not to gain money from investing their surplus money. This is called "*Riba*" in Islam or usury and this is prohibited in christian religions as well as in Islam. The conventional banking system is based on interest which is rejected by most Muslim people. The alternative banking system is Islamic banking which is based on the participating finance and profit and loss sharing and does not contain any type of interest.

The research is conducted in the form of a content analysis, which includes a comparison of annual reports of four banks, and a survey, so a tendency for misintepretation and biased reporting is always possible. The scale of the areas to be covered in the study together with limited time and resoures prevent more in-depth study of all Islamic banks that are applying AAOIFI standards in different areas to generalise the findings.

There are three limitations in this study; first, Bahrain is a new research area, at least with regard to the application of the AAOIFI standards. This was proved after studying most Islamic banks operating in the Gulf countries. Bahrain is a unique country in the Gulf region that applying AAOIFI standards; second, there are more than 93 financial institutions which are members of AAOIFI, some of them are recently launching Islamic transactions, and some of these institutions are implementing these standards, but most of them are still applying traditional standards; third, the majority of Muslims look for Islamic banks who abide by the *Sharia'h* requirement to satisfy their needs and prevent them from dealing with forbidden (*haram*) transactions in all Islamic countries. To coincide with these views, a large majority of Islamic bank customers were satisfied with the Islamic bank's name and image and with the bank's ability to provide confidentiality (Naser, 1999).

7 Research Outline

The research is structured into seven chapters. Following this introductory chapter, the second chapter contains the rationale for selecting Bahrain for the study and it investigates Bahrain's general background, its economic development, its financial sector, its banking and applied accounting standards.

Chapter three discusses the literature in the following areas: Islamic banking, the objectives of Islamic banks, and the common differences between Islamic banks and their conventional counterparts. The chapter discusses financial reports, differences between the objectives of financial reports for Islamic banks and their counterpart for conventional banks. Islamic accounting and its objectives and specific characteristics are also discussed in the chapter, as well as the users' attitude toward conventional accounting standards.

Chapter four is dedicated to identifying and presenting the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) as the setter organisation of accounting and auditing standards that govern and regulate financial reports of Islamic banks in particular. This chapter provides details of the AAOIFI, its evolution, its organisational structural and the standards issued and applied by the Islamic banks by the end of 2002.

The fifth chapter discusses the research methodology. This chapter discusses the different methods of data collection selected to achieve the research objectives. Chapter six presents the data analysis by using a content analysis of financial statements of the Islamic banks that are implementing AAOIFI accounting standards and a questionnaire survey of those dealing with Islamic banks and who are preparing their financial reports in Bahrain. Summary findings of the study and recommendations are presented in chapter seven.

Chapter Two

The Rationale for Selecting Bahrain for the Research Study

2. Introduction

Islamic banks have been established to assist Muslims, mankind, Islamic and other societies in using money in a beneficial manner consistent with the principle of Islamic *Sharia'h* and other divine religions. These banks have now become an important means of attracting deposits from those who wish to invest in a way consistent with the principles of *Sharia'h*. The Bahrain Monetary Agency (BMA) (2002) states that the Kingdom of Bahrain is one of the most economically free countries in the world, as deemed by the Heritage Foundation, a Western based think tank. It offers attractive investment opportunities with a well-educated English speaking labour force. There are no exchange controls and import duties. Furthermore, Bahrain has no personal or corporate taxation. These advantages encourage financial organisations in general and banks in particular to make this country the base of their operations. The number of banks and financial institutions licensed by the BMA had increased to 367 by the end of 2004. In addition, two-thirds of the Islamic financial institutions operating from the Gulf Cooperation Council (GCC) are based in Bahrain (BMA Annual Report, 2004).

This chapter discusses the relative position of Bahrain in the GCC and identifies the reasons for choosing Bahrain as the geographical region for investigation. This chapter further discusses the banking sector of Bahrain, its economic and financial system and Islamic banking. Liberal trade and investment policies have helped Bahrain to maintain stable economic growth for much of the period since the 1980s.

2.1 Reasons for choosing Bahrain for this study

The initial intention of this study was to explore the impact of the AAOIFI standards on the quality of financial reports of Islamic banks in which they operate. However, the primary investigation included all Islamic banks that were members of the AAOIFI in 2002 especially those who were operating in the Gulf area. After examining most annual reports of Islamic banks ending in 2002, it was found that the application of such standards was mainly in the state of Bahrain. Moreover, Bahrain Monetary Agency (2002) states that:

1. Bahrain is the leading international financial centre in the Gulf region. It hosts a mix of over 367 diverse financial institutions including 52 Offshore Banking Units (OBUs), 37 investment banks of which 16 specialise in Islamic banking, 24 commercial banks, of which 14 are foreign owned and 5 of which are Islamic banks. In addition, there are 31 representative offices of international banks, 18 money changers, 16 investment advisories, and about 189 other financial service providers including those of fund management, insurance companies, as well as the professions. Furthermore, the Bahrain Stock Exchange was established in 1989.
2. The Kingdom of Bahrain pursues a dual banking system, where Islamic banks operate side by side with their conventional counterparts. In fact, the emergence of Islamic banks in the Kingdom drew on the same environment that led to the development of Bahrain as an international financial centre. The BMA affords equal opportunities and treatment for Islamic banks as for conventional banks.

3. Bahrain provides an attractive base for industry due to its tax-free environment. It has a stable currency, well developed infrastructure, low energy and operating costs and it has good road, sea and air link to major regional markets. Many companies use the country as a hub for access to the region. The Kingdom of Bahrain is linked to Saudi Arabia by a causeway (26 kms long).
4. The country is one of the most economically free countries in the world, as deemed by the Heritage Foundation, a Washington based think tank, and it offers attractive investment opportunities with a well educated English speaking labour force. There are no exchange controls and import duties are low. Bahrain also has no personal or corporate taxation. It has a great tradition of tolerance and understanding of the non-Arab way of life.
5. Bahrain is not only the host for a considerable number of Islamic banks and financial institutions, but also for a range of institutions supporting these organisations. Support takes various forms including standards setting:
    a. Hosting the Accounting and Auditing Organisation of Islamic Financial Institutions (AAOIFI).
    b. Establishing credit rating and information agency; namely, the International Islamic Rating Agency (IIRA).
    c. Hosting the General Council for Islamic Banks and Financial Institutions (GCIBFI).
    d. Hosting training development institutions such as the Bahrain Institute of Banking and Finance (BIBF).

2.2 General background about Bahrain

The Kingdom of Bahrain is an archipelago of 33 islands with a total area of 670 sq. km, situated midway down the western shore of the Arabian Gulf. This small group of islands is linked by causeway to Saudi Arabia. Bahrain recently became a constitutional monarchy. Since 1948, the United States Navy has made Bahrain its headquarters for activity in the Persian Gulf. At present, its base occupies more than 60 acres of land in Manama (the country's capital) and is the headquarters of the U.S. Navy's Fifth Fleet. The State of Bahrain gained independence from the United Kingdom (UK) in 1971. A constitution was introduced in 1973, which provided for an elected National Assembly. This was dissolved in 1975 and has not been reinstated, but an appointed Consultative Council was set up in 1992 and enlarged at the beginning of its second term in 1996 and has been transformed in 2002 into a constitutional monarchy with a democratically elected parliament. Sheikh Hamad declared himself King and Bahrain a constitutional monarchy.

2.3 Economic development

From the early 1930s Bahrain's economy has been thriving on the refining of oil, extracted both locally and from offshore oil fields, while the exploitation and liquefaction of natural gas continues to provide abundant low cost energy. The economic diversification and transformation of Bahrain started in the 1970s. Bahrain is a member of the World Trade Organisation (WTO) and has subscribed to the principles of a free market economy. The major industries are petroleum processing and refining, aluminium smelting and downstream production, ship repairing, offshore banking and finance, insurance, business services and tourism. The 1990s have witnessed a number of measures to encourage foreign investment, including options for 100% foreign ownership of companies, favourable tax concessions, simplified investment procedures and generous subsidies for companies employing Bahraini nationals. The Bahrain Promotions and Marketing Board and the Bahrain Development Bank are directly involved in promoting investment, including the right for foreign nationals to own property in Bahrain.

Population

According to the latest published data in the BMA Annual Report 2004, Bahrain's population increased from 654,619 at the end of 2001 to 707,160 at the end of 2004 or by 2.6%. The population of Bahrainis has increased by 2.4%, and the non-Bahraini population grew by 2.9% per year. Table 2.1 shows the distribution of population in Bahrain:

Table 2.1: Population

	2001	2004
Total population	**654 619**	**707 160**
Bahraini	407 959	438 209
Non-Bahraini	246 660	268 951
Annual population growth (%)	2.7	2.6
Annual Bahraini population growth (%)	2.4	2.4
Annual non-Bahraini growth (%)	3.0	2.9
Population under age 15	**180 974**	**206 325**
Population above age 65	**16 586**	**17 798**
Total fertility rate per Bahraini women	**3.0**	

Source: BMA Annual Report2004.

Employment

Total employment increased in 2004 by 5.1% from 188,420 in 2001 to 285,390 in 2004. In addition, total employment as a percentage of total population increased from 28.8% in 2001 to 40.4% in 2004.

Employment distribution, as revealed in Table 2.2 below, illustrates that the private sector makes up the largest part of employment in the economy, accounting for 86.8% of total employment, whilst the public sector accounts for 13.2%. Male and female employment in the private sector accounted for 89.1% and 10.9% respectively, while in the public sector 58.2% and 41.8 % respectively.

Bahraini employment in the private sector increased in absolute terms from 157 396 in 2001 to 247,814 in 2004, or by 6.3%. Bahraini employment accounted for 26.7% of private sector employment in 2004. Non-Bahraini employment in the private sector made up 73.3% of total private sector employment in 2004. With respect to the public sector, Bahraini nationals made up 89.8% of total public sector employment, whereas non-Bahrainis accounted for only 10.2% in 2004. Table 2.2 shows the distribution of employment over these three years 2001 - 2004.

Table 2.2: Distribution of employment

	2001	2004
Total population	654 619	707 160
Total employment	188 420	285 390
As % of total employment	28.8	40.4
Private sector	**157 396**	**247 814**
As % of total employment	83.5	86.8
Male	136 782	220 878
Female	20 614	26 936
Bahraini	53 135	66 229
As % of private sector of employment	33.8	26.7
Non-Bahraini	104 261	181 585
As % of private sector employment	66.2	73.3
Public sector	**31 024**	**37 576**
As % of total employment	16.5	13.2
Male	19 203	21 861
Female	11 821	15 715
Bahraini	27 734	33 754
As % of public sector of employment	89.4	89.8
Non-Bahraini	3 290	3 822
As % of public sector employment	10.6	10.2

Source: BMA Annual Reports 2001 & 2004.

The average monthly wages in the private sector increased from BD 355 in 2003 to BD 364 in 2004, or by 2.5%, while average monthly wages in the public sector increased from BD 555 to BD 574, or by 3.4%.

2.3.1 Domestic economic developments

Gross Domestic Product (GDP)

Table 2.3 shows that in the period 2001 – 2004, at the constant prices (1989 = 100), the real GDP growth was 18.7% compared with growth percentage 15.5% in the period 1998 – 2001. The value added of the non-financial corporation sector rose by 16.0% in the period of 2001 – 2004 compared with a rise also in the period of 1998 – 2001. This rise (in the period of 2001 – 2004) was mainly attributed to an increase in the value added of social and personal services by

157.9%, construction by 24.7%, electricity and water by 22%, and manufacturing by 20.5%.

Similarly, the value added of the financial corporations sector rose tremendously in the period 2001 – 2004 by 75.1% compared with the rose in the period of 1998 – 2001 by 17.8%. The insurance sector saw the most remarkable rise (112.3%), while offshore financial institutions grew by 70.0% compared with contraction in the sector in the period 1998 – 2001.

On the other hand, growth in the added value of the government services sector registered 66.2% in the period of 2001 – 2004. However, this sector has registered recession in the period 1998 – 2001 when growth fell by (-24.3%). Accordingly, the government sector contributed to GDP negatively in the period 1998 – 2001 and positively in the period 2001 – 2004.

Table 2.3 Gross Domestic Product (GDP) at Constant 1989 price: 1989= 100

Sector	1998	2001	2004	Period growth	
				98 - 01	01 - 04
1- The Non-Financial Corporations	**1 668.0**	**1 926.8**	**2 234.3**	**15.5%**	**16.0%**
- Agriculture & Fishing	21.9	22.1	21.5	1.0%	-2.7%
- Mining & Quarrying	375.6	470.4	428.9	25.2%	-8.8%
- Crude Petroleum & Natural Gas	373.4	467.9	424.1	25.3%	-9.4%
- Manufacturing	286.1	332.4	400.7	16.2%	20.5%
- Electricity & Water	50.6	57.5	70.3	13.6%	22.3%
- Construction	83.7	108.6	135.4	30.0%	24.7%
- Trade	345.0	351.0	400.5	1.7%	14.1%
- Hotels & Restaurants	52.7	63.4	75.4	20.3%	18.9%
- Transport and Communication	179.4	233.3	288.5	30.0%	23.7%
- Social & Personal Services	82.2	45.4	117.0	-44.8%	157.9%
Private Education Services	-	-	46.1		
Private Health Services	-	-	13.9		
Other Social & Personal Services	-	-	57.0		
- Real Estate & Business Activities	-	-	296.1		
Real Estate	190.9	242.7*	245.2		
Business Activities	-	-	50.9		
2- The Financial Corporations	**430.6**	**447.3**	**783.4**	**17.8%**	**75.1%**
- Financial Institutions	136.7	134.9	217.4	-1.3%	61.1%
- Offshore Financial Institutions	191.9	229.3	389.6	19.5%	70.0%
- Insurance	102.1	83.1	176.4	-18.6%	112.3%
3- Government Services	**379.7**	**287.3**	**477.6**	**-24.3%**	**66.2%**
- Government Education Services	-	-	116.5		
- Government Health Services	-	-	55.1		
- Other Government Services	-	-	306.0		
4- Private non-profit institution serving household	**1.0**	**1.2**	**1.9**	**20.0%**	**58.3%**
5- Households with Employed Persons	**15.3**	**16.9**	**18.9**	**10.5%**	**11.8%**
6- less: imputed services charge	**(182.4)**	**-**	**-**		
	-	**-**	**-**		
8- Minus Financial Intermediation Services Indirectly Measured	**-**	**(163.7)**	**(323.4)**		**-97.5%**
9- GDP at Producer Prices	**-**	**2 673.6**	**3 192.7**	**19.4%**	**19.4%**
10- Import Duties	**57.6**	**54.0**	**44.9**	**-6.3%**	**16.9%**
Total GDP	**2 369.8**	**2 727.6**	**3237.6**	**15.5%**	**18.7%**

*** Real stat & Business activities.**

- **Sources: BMA Annual Reports; 1998, 2001, and 2004.**

2.3.2 Trade balance of Bahrain

According to BMA annual reports (1998, 2001 and 2004), the trade balance changed from a deficit of BD -111.3 million in 1998 to a surplus of BD 482.0

million in 2001. The surplus in the second period (2001 - 2004) has witnessed a slight recession and recorded a surplus BD 388.8 million in 2004. The main reason attributed to the growth of imports. The value of both total exports and imports registered an increase. Table 2.4 shows that the total exports recorded an increase of 69.6% in the period 1998 - 2001, while the second period 2001 - 2004 recorded an increase of 35.6%. Figures for total imports and foreign trade recorded an increase of 19.5% in the period 1998 - 2001 and of about 52.1% in the overall period 2001 - 2004. The most important items of the trade balance are:

Exports

The value of oil exports increased tremendously by 117.3% in the period 1998 - 2001 from BD 637.0 million in 1998 to BD 1 384.1 million in 2001. The next three years (2001- 2004) recorded an increase by 50.9% from BD 1 384.1 million in 2001 to BD 2 087.3 million in 2004. New export products have been added such as *Abu Safa'a,* base metals and articles thereof, products of chemical and allied industries.

Imports

Table 2.4 shows the value of oil imports rose from BD 274.0 million in 1998 to BD 578.4 million in 2001 or by 111.1%. The value of oil imports increased from BD 578.4 million in 2001 to BD 1 039.7 in 2004 or by 79.8%. The value of non-oil imports increased by 4.0% in the period 1998 – 2001 and by 36.5% in the next three years 2001 - 2004. Imports of other elements such as machinery and base metals and articles thereof, transport equipment, and textile and textiles articles appeared in the balance of trade in the period 2001 - 2004.

Table 2.4: Foreign trade balance

Main group	BD Millions			Changes %	
	1998	2001	2004	98 – 01	01 - 04
Total exports	**1 229.6**	**2 084.8**	**2 827.0**	**69.6**	**35.6**
Oil exports	637.0	1 384.1	2 087.3	117.3	5..8
Abu Safa'a			769.3		
Petroleum products	-	1 318.0	1 318.0		0.0
Non-oil export (fob) 1/	592.6	700.7	739.7	18.2	5.6
Base metals and articles thereof			368.2		
Textile and textile articles			93.1		
Products of chemical and allied industries			81.0		
Machinery and appliance, electrical equipment			34.4		
Total imports	**1 340.9**	**1 602.8**	**2 438.2**	**19.5**	**52.1**
Oil import	274.0	578.4	1 039.7	111.1	79.8
Non-oil import	1 066.9	1 024.4	1 398.5	4.0	36.5
Machinery and appliances, electrical equipment			361.0		
Products of chemical and allied industries			143.7		
Transport equipment			182.5		
Textiles and textiles articles			82.7		
Base metals and articles thereof			140.7		
Trade balance	**-111.3**	**482.0**	**388.8**	-	- 19.3

Source annual reports of BMA, 1998, 2001, and 2004

Non-oil trade with GCC

The Bahrain non-oil trade surplus with the GCC countries increased from BD 60.4 million in 1998 to BD 148.2 million in 2001. However, this decreased to BD 41.4 million in the period ending in 2004. This decrease was a result of an increase in non-oil imports from the GCC countries by 8.3%. Non-oil exports to GCC countries accounted for 37.5% of the total non-oil exports while non-oil imports from these countries represent 16.9% of the total non-oil imports. Saudi Arabia and the United Arab Emirates remained the main trading partners among the GCC countries. Table 2.5 below shows the amount of trade with GCC countries.

Table 2.5: Non-oil trade with GCC

Country	1998			2001			2004		
	export	import	balance	export	imports	balance	export	import	balance
Kuwait	20.6	4.7	15.9	15.7	6.8	8.9	26.2	13.1	13.1
Oman	6.3	3.9	2.4	87.6	4.9	2.7	5.7	6.2	-0.5
Qatar	13.9	2.8	11.1	26.0	3.9	22.1	26.0	9.8	16.2
Saudi. A	107.6	76.4	31.2	114.4	92.1	22.3	180.0	137.3	42.7
U.A.E.	35.3	35.7	-0.2	30.6	40.5	-9.9	39.2	69.3	- 30.1
Total	183.9	123.5	60.4	194.3	148.2	46.1	277.1	235.7	41.4

Source: BMA Annual reports of, 1998, 2001 and 2004.

2.3.3 Balance of payments (BOP)

Current account

The current account rose from a deficit of BD (– 292.3) million in 1998 to a surplus of BD 85.4 million in 2001 reaching BD 156.1 million in 2004. This rise was due to the increase in the following elements:

1. Increase in goods from a deficit of BD (-10.7) million in 1998 to a surplus of BD 605 million in 2001 and BD 558.5 (slight recession) in 2004. This was due mainly to the increases in the exports of oil and oil products.
2. The services industry. This sector rose from BD 27.4 million in 1998 to BD 78.2 million in 2001 and to BD 234.9 million in 2004. This was due to the increases in the travel sector.
3. Income. In contrast to the above elements this sector has witnessed a decrease from BD (-60.9) million in 1998 to BD (-120.9) million reaching the lowest point in 2004 by BD (-216.2) million. This was due mainly to an increase in expenditure on the investment sector.

4. Current transfers. This element has also witnessed recession from BD (-248.1) million in 1998 to BD (-475.3) million in 2001 and BD (-421.1) million in 2004. This was attributed to worker remittances.

Capital and financial account

The capital and financial account registered a net outflow of BD 187.5 million in 2004, compared with a net inflow of BD (-165.7) million in 2001 whereas this account recorded outflow BD 52.3 million in 1998. This was due to the changes in the financial accounts during that period of time. For example, an increase in Bahrainein portfolio assets by BD 1,463.6 million as a result of the increase in the banks portfolio assets in the level of investment in mutual funds.

The last three years (2001-2004) witnessed an increase in other investment assets and liabilities by BD 3,677. 3 million and BD 4,912.2 million respectively to end with a net inflow of BD 1,234.9 million in 2004 compared with a net inflow of BD 450.1 million in 2001 and only 328.2 million in 1998.

The last six years witnessed an increase in other investments; assets increased from BD 2,114.3 million in 2001 to BD 3,677.3 million in 2004; liabilities increased from BD 1,664.2 in 2001 to BD 4,912.2 million in 2004. However, the reserve assets registered a surplus for the sixth consecutive year. The net surplus increased from BD 6.3 million in 1998 to BD 46.4 million in 2001 to reach BD

59.4 million in 2004. Table 2.6 shows that Balance of Payment in 1998, 2001 and 2004.

Table 2.6: Balance of payments (BD Millions)

Items	1998	2001	2004
1. Current account (a + b + c + d)	**- 292.3**	**85.4**	**156.1**
a. Goods	**- 10.7**	**605.4**	**558.5**
General merchandise	-	575.1	520.1
Exports	1 229.6	2 096.9	2 827.0
- Oil and oil products	664.4	1 475.0	2 163.2
- Non oil	565.2	621.9	663.8
Imports	- 1 240.3	- 1 521.8	-2 306.9
- Oil and oil products	- 334.9	1 646.5	-1 125.1
- Non oil products	- 905.4	- 875.3	-1 181.8
Repairs on goods	-	30.3	38.4
b. Services (net)	**27.4**	**76.2**	**234.9**
- Transportation	- 62.4	- 56.2	69.5
- Travel	84.3	143.0	179.5
- Insurance	- 10.1	- 9.7	- 13.1
- Others	15.8	- 0.9	- 1.0
c. Income (net)	**- 60.9**	**- 120.9**	**- 216.2**
Investment income	- 60.9	- 120.9	- 216.2
- Direct investment income	- 226.6	- 268.2	- 248.0
- Portfolio income	191.7	180.4	175.3
- Other investment income	- 26.0	-33.1	- 143.5
d. Current transfers (net)	**- 248.1**	**- 475.3**	**- 421.1**
- Workers' remittances	-	- 483.9	- 421.1
2. Capital and financial account (net) (A + B)	**52.3**	**- 165.7**	**187.5**
A. Capital account	**37.6**	**37.6**	**18.8**
- Capital transfers	37.6	37.6	18.8
B. Financial account (1 + 2 + 3 + 4)*	**14.7**	**- 203.3**	**- 206.3**
1. Direct investment	- 0.5	- 51.0	- 64.0
- Abroad	- 68.0	- 81.2	- 389.4
- in Bahrain	67.5	30.2	325.4
2. portfolio investment	- 319.3	- 556.0	- 1317.8
- Assets	-	- 544.5	- 1463.6
- Liabilities	-	- 11.5	145.8
3. Other investment	328.2	450.1	1234.9
- Assets	-	2 114.3	- 3677.3
- Liabilities	-	- 1664.2	4912.2
4. Reserve assets	6.3	- 46.4	- 59.4
3. Errors and omissions	**240.0**	**80.3**	**31.4**

**** Financial transactions. A negative sign means net outflows/increases in external assets.***

Source: Annual Reports of BMA, 1998, 2001, and 2004.

International Investment Position (IIP)

The International Investment Position (IIP) provisional data for the year 2004 indicates that Bahrain continued to enjoy the position of net external creditor. The net international investment position rose from BD 2.0 billion at the end of 2003 to BD 2.1 billion in 2004, or by 5,0%. Foreign assets rose by 16.0% from BD 33.8 billion in 2003 to BD 39.2 billion in 2004 as a result of the increase in other investment assets by 15.2%. Similarly, foreign liabilities rose from BD 31.8 billion in 2003 to BD 37.1 billion in 2004 or by 16.7% due to the increase in other investment liabilities by 17.2%.

Furthermore, Bahrain has already a regional financial services centre specializing in offshore banking. Bahrain is intent on further diversifying its generally liberalized economy. For the time being, the country remains heavily dependent on the oil sector. Petroleum revenues make up about two-thirds of government revenue and export earnings. Hydrocarbons also provide the foundation for Bahrain's two major industries: refining and aluminium smelting. Accordingly, oil prices dramatically affect Bahrain's economy. The relatively high oil prices of recent years have helped Bahrain's real Gross Domestic Product (GDP) to grow at 5.3% in 2003 and 4.6% for 2004. However, these relatively strong growth rates have not kept unemployment from becoming a growing economic and political problem.

In addition, the International Rating Agency assigned Bahrain investment grade status. This reflects solid macroeconomic fundamentals and an improving climate for both foreign direct investment and portfolio investment. Bahrain is a member of the World Trade Organisation (WTO) and is, in fact, the first Gulf Cooperation Council (GCC) country to allow 100 per cent foreign ownership in the region.

2.4 Banking in Bahrain

2.4.1 Historical background

Banking in Bahrain started in the early 20th century when a branch of the Eastern Bank (now Standard Chartered Bank) opened in 1921. This was followed by the establishment of the British Bank of the Middle East (now HSBC) in 1944, the Bank of Bahrain (now the National Bank of Bahrain) in 1957 as the first locally incorporated bank, and the Arab Bank Limited in 1960. These four banks were adequate to meet the needs of the customers in that era, with trade finance and deposit facilities being offered. With the first oil boom in 1973 and the subsequent increase in economic activity, more commercial banks were set up (15 banks between 1969 and 1977).

After the substantial increase in the oil price in the early 1970s, the Gulf countries became recipients of substantial funds. The existing banks in the region felt that they could play a role in reinvesting such funds through a physical presence in the region. However, these banks did not have sufficient capacity to deal with such large amounts of money. This led the BMA to take the initiative to host Offshore Banking Units (OBU's), which were intended to operate throughout Bahrain by providing a mechanism to invest the surplus liquidity of the region.

The availability of OBU's was further enhanced by the increasing desire of Bahrain to diversify its economic base. The first OBUs operating in Bahrain were Citibank and Algemene Bank in 1975. The number of OBUs reached 76 in 1984, but had declined to 52 by 2004, due to international financial developments and a trend towards consolidation within and between banking groups. In 1977 the BMA introduced a third category of banking licence, called an Investment Banking licence (IBs), for banks intending to carry out investment business. The first of these banks was Bahrain Investment Bank in 1977, (some of the institutions are credit card companies, BMA, 2004).

The birth of Islamic banking services in Bahrain dates back to 1978, as already indicated when the Bahrain Islamic bank was established to provide commercial banking services. Islamic banking in Bahrain gained momentum in the early 1980s, when the issue of four new licences, one of which was an offshore banking unit licence, while the rest were investment banking licences. The creation of an Islamic offshore bank was the first of its kind, an illustration of the innovative approach to regulation pioneered in Bahrain. BMA during the 1990s issued a total of eight licences to a diverse group of institutions to enable them to pursue Islamic banking services. At the end of 2004, the total number of Islamic banks operating in Bahrain reached 26, of which four are full commercial banks, three are offshore banking units, and sixteen are investment banks with the remainder being a representative office, investment advisors/brokers, and an Islamic infrastructure funds.

2.4.2 Banking system

The number of banks and financial institutions licensed by the BMA was increased to 367 in 2004. During the year, 23 new licenses were issued to the banking and financial sector. These licenses including 3 full commercial banks, 5 offshore banking units, 1 investment bank, 3 representative offices, 4 investment advisory brokers, 1 money changer, and 6 insurance companies. Table 2.7 illustrates the number of banks and other financial institutions. The total number of employees in the banking and non-bank financial sector was 7,406 in the year 2004 showing a growth of 6.3%. Bahrainis represented 74% of the total number. 5,498 employees were in the banking sector. Table 2.7 shows the number of banks and other financial institutions in Bahrain at the end of 2004.

Table 2.7: Number of banks and financial institutions in Bahrain 2004

Commercial Banks	**24**
of which Islamic banks	5
Offsbore Banking Units	**52**
of which Islamic banks	**3**
Investment Banks	**37**
of which Islamic banks	16
Representative Offices	**31**
of which Islamic Financial Institutions Rep. Offices	1
Specialised Banks	2
Money Changers	18
Financing Companies	1
Investment Advisory	16
Provider of Ancillary Services	5
Broking Companies	3
Capital Market Brokers	13
Insurance Companies and Organisations	165
National Insurance Companies and Reinsurance Companies	12
Foreign Insurance Companies	7
Offshore Insurance Companies	84
Representative Offices	7
Insurance Brokers	30
Surveyors and Loss Adjusters	9
Insurance Consultants	7
Actuaries	9
Total	**367**

Source: BMA, 2004

Bahrain pursues a dual banking system, where Islamic banks operate side by side with their conventional counterparts. The emergence of Islamic banks in Bahrain drew on the same environment that led to the development of Bahrain as an international financial centre. The Bahrain Monetary Agency (BMA) affords equal opportunities and treatment for conventional as for Islamic banks. The geographical distribution of the banking system assets and liabilities at the end of 2004 is illustrated in Table 2.8.

Table 2.8: Geographical distribution of assets and liabilities of banks (US$ Billions)

Countries	Assets			Liabilities		
	FCBs	OBUs	IBs	FCBs	OBUs	IBs
Arab countries	10 465.4	24 304.4	2 157.6	11 577.7	34 008.4	3 493.3
Asia	221.0	9 052.9	85.5	97.3	12 844.8	17.9
Americas	602.7	20 421.4	1 572.6	98.9	8 322.7	1 269.7
Western Europe	908.5	27 022.2	1 497.5	449.5	27 699.8	471.9
Others	41.8	2 581.3	0.0	16.0	506.5	60.4
Total	12 239.4	83.0	382.2	5 313.2	12 239.4	5 313.2

Source: BMA Annual Report 2003. FCBs = full commercial Banks, OBUs = Offshore Banking Units and IBs = Investment Banks.

Commercial banking

At the end of 1998, Bahrain's commercial banking sector comprised 19 Full Commercial Banks (FCBs), two of which were Islamic banks. The number of commercial banks increased year by year. The commercial banking sector at the end of 2001 comprised of 21 full commercial banks, four of which were Islamic banks. The full commercial banks in Bahrain numbered 24, five of which were Islamic banks. The consolidated balance sheet of the banking system has witnessed rapid growth during the second period (2001 – 2004) of more than15% in the total consolidated balance sheet of banking system. The investment banks grew by 55.0% in the mentioned period while in the previous period, these banks grew by 29.0%. Commercial banks increased their assets from US$ 8.7 billion at the end of 1998 to US$ 10.3 billion at the end of 2001 recording a growth of 18.4%. This growth continued reaching US$ 18.4 billion at the end of 2004 recording a growth of 40.8% in the period 2001 – 2004. Table 2.9 shows the consolidated balance sheet of the banking system.

Table 2.9: Consolidated balance sheet of banking system (US$ Billions)

Items	1998	2001	2004	Change %	
				98 - 01	01 - 04
Commercial banks	8.7	10.3	14.5	18.4	40.8
Offshore banking units	87.6	88.4	98.1	1.0	10.8
Investment banks	3.1	4.0	6.2	29.0	55.0
Total	99.4	102.7	118.8	3.3	15.7

Source: BMA Annual Reports 1998, 2001, and 2004

Offshore banking units

The number of licensed Offshore Banking Units (OBUs) totalled 52 at the end of 2004 compared with 47 offshore banks licensed in 2001 and 48 at the end of 1998. The number of Islamic offshore banking units was 2 in 1998, 2 in 2001, and 5 in 2004. The aggregate assets/liabilities of the OBUs increased from US$ 87.6 billion at the end of 1998 to US$ 88.4 billion at the end of 2001 and increased to reach US$ 98.1 billion in 2004.

Investment banking

The number of licensed Investment Banks (IBs) at the end of 1998 was 30 investment banks. This number increased to reach 32 in 2001 and 37 investment at the end of 2004. Islamic investment banks numbered 10 in 1998, 16 Islamic banks in 2001 and 18 in 2004. The aggregate assets/liabilities of the IBs increased by 29.0%, from US$ 3.1 billion at the end of 1998 to US$ 4.0 billion at the end of 2001 and grew to US$ 6.2 billion in 2004 showing 55.0% growth in the period 2001 - 2004.

Islamic banking

The Islamic banking and finance industry in Bahrain encompasses a unique blend of institutions of different categorise. Some are dedicated fully to Islamic banking services; examples of these are Bahrain Islamic Bank, Ashamil Bank of Bahrain, and Al Baraka Islamic Bank. Other Islamic banks are resident banks with originally conventional banking activities that saw potentially profitable opportunities in diversifying their services to Islamic banking. Arab Banking Corporation is a notable example of this. A final category of Islamic banks operating in Bahrain is represented by major multinational banks. A good example here would be Citi Islamic Investment Bank (a subsidiary of Citicorp). The number of licensed Islamic banks (commercial banks, offshore banking units, and investment banks) at the end of 2004 totalled 26. It is important to emphasise here that all financial institutions which provide conventional and Islamic financial services have abided by the appropriate BMA regulations. There are currently 26 Islamic financial institutions licensed in Bahrain. Table 2.10 shows the Islamic banks and financial institutions in Bahrain.

Table 2.10: Islamic banks and financial institutions in Bahrain June 2002 *

Bank name	Date of establishment
Full commercial banks (4)	
Al Baraka Islamic Bank	21. 10. 2001
Kuwait Finance House-Bahrain	09. 12. 2001
Bahrain Islamic Bank	29. 10. 1978
Shamil Bank of Bahrain	23. 02. 1993
Offshore banking units (3)	
Kuwait Turkish Evkaf Finance House	13. 02. 2002
Al Baraka Banking Group	06. 01. 1998
Shamil Bank of Bahrain	19. 01. 1982
Investment banks (16)	
ABC Islamic Bank	20. 07. 1985
ABC Islamic Fund	31. 10. 1989
Al-Amin Bank	19. 05. 2001
Al Baraka Islamic Bank	30. 09. 1983
Al khaleej Finance and investment	04. 02. 1981
Al khaleej Islamic investment Bank	06. 04. 1999
Arab Islamic Bank	14. 12. 1989
Citi Islamic Investment Bank	17. 03. 1996
Faysal Investment Bank of Bahrain	22. 02. 1994
Gulf Finance House	02. 08. 1999
International Credit Company	19. 05. 2001
Investor Bank	03. 09. 1997
First Islamic Investment Bank	20. 08. 1996
International Investment Bank	09. 12. 2001
Liquidity Management Centre Company	11. 06. 2002
Noriba Bank	04. 05. 2002
Representative offices (1)	
International Investor Group	09. 05. 1995
Investment advisors/brokers (1)	
Islamic Finance Consultants	25. 03. 1999

Source: Bahrain Monetary Agency

- ***In addition to the above the IDB Islamic infrastructure, specially licensed by Amery decree, is also based in Bahrain***

The consolidated balance sheet of Islamic banks (excluding restricted accounts) shows total assets of US$ 2.65 billion in March 2002. This compares with US$ 1.3 billion at the end of 1998. The consolidated total assets of Islamic banks have almost doubled in less than three years. Including the restricted accounts the total assets of Islamic banks operating in Bahrain reached $8.4 billion by the end of 2001. Tables 2.11 and 2.12 provide the consolidated balance sheet of the Islamic banks in the Kingdom of Bahrain. These tables include full commercial banks, offshore banking units, and investment banks.

Islamic banks employed a total of 834 staff at the end of 2001 of which 91% were Bahraini. This high ratio of Bahrainisation reflects the high quality training provided by the Bahrain Institute of Banking and Finance (BIBF). Islamic banks operating in Bahrain diversified regionally. The main markets of their product are the GCC, the European Union and North America. The total foreign assets of the Islamic banks increased from US$ 1.6 billion at the end of 2002 to US$ 2.1 billion at the end of 2003, or by 31.3%. Similarly, total foreign liabilities increased from US$ 1.3 billion at the end of 2002 to US$ 1.9 billion at the end of 2003, or by 46.2%. As a result, net foreign assets of the Islamic banks amounted to US$ 0.2 billion at the end of 2003.

Table 2.9: Consolidated balance sheet of the Islamic banks: Full Commercial Banks, Offshore Banking Units and Investment Banks

Liabilities

U.S. Dollar Million

	Domestic Liabilities						Foreign Liabilities						
End of period	Banks2/	Private non banks	General Gov't	Capital & Reserves	Others	Total	Banks	Non-Banks	H.O. & Affiliates	Capital & reserves	Others	Total	Total Liabilities
1998	68.7	472.0	20.6	210.6	17.2	789.1	69.9	138.1	44.4	306.5	0.0	558.9	1348.o
1999	183.9	516.3	20.6	352.5	15.7	1089.0	61.3	102.9	87.0	334.9	2.1	588.2	1677.2
2000	140.9	576.9	33.2	281.4	38.5	1070.9	72.7	124.5	122.9	525.4	1.1	846.6	1917.5
2001	117.1	654.4	18.4	403.9	22.8	1216.6	311.4	173.0	223.2	530.9	3.0	1241.5	2458.1

1/ Includes Unrestricted investment accounts

2/ Includes Head Offices and Affiliates

Source: Bahrain Monetary Agency

Table 2.10: Consolidated Balance Sheet of the Islamic Banks: Full Commercial Banks, Offshore Banking Units and Investment Banks

Assets

U.S. Dollar Million

	Domestic Assets						Foreign Assets						
End of period	Cash	Invest with Banks/2	Invest w/ Private Non-banks	Invest w/ Govt.	Others	Total	Invest with Banks/ 2	Invest w/ private non-banks	Secure -ities	H.O, & others Affiliates	Others	Total	Total assets
1998	3.4	468.3	202.3	0.0	54.2	728.2	85.0	372.5	72.2	80.4	9.7	619.8	1348.0
1999	5.1	598.0	242.4	0.0	55.5	901.0	110.4	446.7	85.1	120.0	14.0	776.2	1677.2
2000	4.2	713.1	285.3	0.0	69.2	1071.8	186.8	370.0	88.3	184.1	16.5	845.7	1917.5
2001	4.3	733.9	333.9	21.5	67.9	1161.5	172.1	489.3	94.5	529.9	10.8	1296.6	2458.1

1/ Includes Unrestricted investment accounts

2/ Includes Head Offices and Affiliates

Source: Bahrain Monetary Agency

2.4.3 Insurance companies

From a modest beginning in 1950, the insurance industry in Bahrain has grown to become a prominent element within the country's financial services sector. The first insurance agency in Bahrain, and within the Arabian Gulf, was established in May 1950 when the United Kingdom's Norwich Union Fire Insurance Society Ltd appointed Messrs Yusuf bin Ahmed Kanoo to be their 'sole and principle agents for Bahrain's Islands.

In the 1970s, following the rise in world oil prices Bahrain became the financial centre for the region. A number of new insurance companies were formed in Bahrain, among them being Bahrain Insurance Company (1969) (which is now Bahrain National Insurance Co. following the merger with National Insurance Co.), Al-Alia Insurance Company (1976) and Bahrain Kuwait Insurance Company (1976). Bahrain's domestic insurance market is comprised of 12 national companies and 9 branches of foreign insurance companies conducting direct insurance business in the Kingdom and carrying out direct insurance business in the Kingdom of Bahrain (BMA 2004). The total premiums amounted to BD 90.1 million showing an increased percentage of 14.1% compared with previous year. The sector employed 923 employees in 2004 and 572 employees were Bahraini who therefore made up 62% of the workforce. Table 2.13 shows the financial position of national insurance companies.

Table 2.13: financial position of national insurance companies 2004

National insurance companies	2002	2004	%
Shareholders' equity	48 043	102 537	133.4
Paid up capital	28 637	67 931	137.2
Retention	20 797	29 115	49.0

Source: BMA 2004

2.5 Bahrain financial sector

Bahrain's small economy notwithstanding, the financial system is well diversified. In 1999, the financial system in Bahrain comprised 176 financial institutions. This included 19 full commercial banks (FCBs), 48 offshore banking units (OBUs), 33 investment banks (IBs), 2 specialized banks, 19 money changers, 36 representative offices, 6 foreign exchange and money brokers, and 13 investment advisory and other financial services. The sector's contribution to the GDP is around 23%, more or less the same share as the oil sector. Banks are profitable, adequately capitalized, and hold high quality assets. The sound management of Bahrain's banks together with the BMA's prudent regulatory and supervisory policies have enabled the sector to withstand the recent volatility of world financial and oil markets.

Bahrain's transparent legal framework supports the sector's growing role as a major financial centre in the region. The financial sector is open to foreign investors with virtually no restrictions on capital ownership. The BMA has successfully introduced and enforced international standards and best practices in accounting, auditing, prudential regulation, and banking supervision. The BMA's recent efforts to develop a comprehensive regulatory and operational framework for Islamic banking will further help to reinforce Bahrain's position as a leading Islamic financial centre.

The BMA also applies a comprehensive and effective off and on-site monitoring system of financial institutions, complying in general with the standards set out in the Basle Core Principles for Effective Banking Supervision. Further improvements are still being pursued in the following areas: (i) greater legal independence of supervisory authorities, (ii) the provision of additional resources for financial supervision, and (iii) the legal definition of permissible "banking activities" and "banks".

The IMF noted in its report that the BMA had achieved full compliance with 24 of the 30 Core (and sub-core) Principles and is largely compliant with another five (4 core and 1 sub-core) Principles. These 29 Principles cover virtually all of the supervisory factors that broadly encompass the fundamentals of a sound supervisory system (IMF Annual Report, 2003).

2.5.1 Financial policies

Efforts are being made within the framework of a medium-term expenditure strategy to promote fiscal consolidation by increasing non-oil revenues and restructuring expenditures. The ultimate objective is to balance the budget by 2006. The combination of expenditure and revenue measures currently under consideration will allow the government to accommodate prospective pressures. Such pressures include retrenchment costs in the context of privatizing public sector activities, the upfront cost of the proposed early retirement scheme and the cost of growing healthcare and education needs. In addition, expenditure restraint is being exercised through the existing freeze on the size of the civil service and the relative wage structure. However, at the same time the government is aware of the need to maintain the attractiveness of civil service employment in order to attract highly qualified and skilled employees so as not to erode the capacity of the government to play an effective role in the economy.

Similar favourable trends are projected for the balance of payments in 2000 and beyond. However, the authorities remain mindful of the vulnerability of the external position to developments in world prices of oil and aluminium. On the basis of the IMF's WEO price projections, Bahrain's oil export prices are expected to initially rebound to US$ 23 per barrel before settling at around US$ 17.5 per barrel.

Based on the assumption that the existing agreement on the Abu Saafa oil field is maintained and production from the Awali field declines by 1% a year, revenues from oil and oil-related exports are expected to reach about US$ 3 billion. With the continued implementation of diversification policies non-oil exports are projected to increase by about 4% a year. Efforts aimed at consolidating the fiscal position and promoting export-oriented private sector investment would largely improve the external position.

The conduct of monetary policy continues to be geared towards maintaining the *de facto* link between the national currency and the U.S dollar. Together with prudent and effective supervision of the financial system, this policy has contributed to provide low inflation and interest rates in line with those prevailing in the USA.

2.5.2 Regulatory environment and supervisory authority

The Bahrain Monetary Agency (BMA) was established under law 23 in 1973 and *inter alia*, authorised to specify the form and manner in which a bank operating in the country should make public the balance sheet and the profit and loss statement of all operations carried out during the year. The law decrees that an independent auditor must certify the accounts. Publication of financial statements should take place within a maximum period of three months after the end of every financial year, although an extension may be granted if there are justifying circumstances. In addition to the annual audited accounts, banks are required to submit to the BMA monthly statements on assets, liabilities and foreign exchange positions; also quarterly and half-yearly reports of a comprehensive nature both on a consolidated and unconsolidated basis.

All banks in Bahrain must appoint a technically qualified auditor acceptable to the BMA to ensure the independence and integrity of the auditing process. An auditor's report on the annual balance sheet and the profit and loss statement must be submitted with the board of directors' report to the annual meeting of shareholders for discussion and approval.

2.5.3 Significant accounting principles and practices

Until 1992, there was no legislation prescribing accounting policies to be followed nor was there a prescribed minimum level of disclosure. Management and the auditor had considerable discretion in determining the accounting policies that were to be followed. As a result, auditors' reports were at variance making reference to proper books of account. International accounting guidelines were generally accepted for the auditing and accounting process (Capital Intelligence, 1999-2000).

Since the end of the 1992 financial year, the BMA required all banks to produce statements in accordance with IAS and, without exception, auditors' reports. Therefore, they referred to International Auditing Standards. Further, locally incorporated and publicly quoted banks have been required to publish financial statements on a quarterly basis. These statements need not be audited, but should be reviewed by external auditors and published within eight weeks of the end of the quarter. The following significant accounting principles have been applied (Hussain *et al*, 2002):

- Accounting Convention. Financial statements are prepared under the historical cost convention, modified in the case of some banks by the revaluation of premises and equipment in respect of certain subsidiaries.
- Income and Expenses. These are generally recognised on an accrual basis.
- Foreign Currency. These transactions are translated to the currency of the bank's balance sheet at rates prevailing on transaction dates. Assets and liabilities denominated in foreign currencies are translated at rates prevailing at the year-end and any resulting gains or losses are taken as income.
- Trading Securities. These are generally stated at market value at the balance sheet date, although some banks show the lower cost or market value.
- Investment Securities. These are stated at cost, with provision being made for any permanent decline in value.
- Loans and Advances. These are the stated net of accumulated provisions. They are placed on a non-performing status as soon as payments of interest or repayments of principle are 90 days past due.
- Provision for Bad and Doubtful Debts. Special and general provisions for loan losses are made on the basis of a continuous appraisal of the lending portfolio, taking into account the bank's previous experience and current economic conditions. The general provision covers doubtful debts which are likely to be

present in any portfolio of bank advances, but which have not yet been specifically identified.

- Depreciation. Freehold Land is not depreciated. The cost of leasehold improvements is depreciated by equal annual instalments over the period of the lease. The cost of other fixed assets is depreciated by equal annual instalments over their estimated useful lives.
- Revenue Recognition. Interest income is generally accounted for on an accrual basis. Loan interest that is 90 days or more overdue is excluded from income until received in cash. Dividend income, fees and commissions are normally accounted for as and when received.
- Taxation. There is no tax on corporate income in Bahrain. Taxation on foreign operations is provided at the rates applicable in each location.
- Employees' Terminal Benefits. Provision is made for an amount payable under Bahraini law applicable to employees' accumulated period of services at the balance sheet date.
- Fiduciary Assets. These are held in trust or in a fiduciary capacity and are not included in financial statements.

The financial sector remains potentially one of the main engines of growth for Bahrain's economy and one of the most vibrant in the region. To ensure effective supervision and mitigate risks common across the components of the financial sector, the Bahrain Monetary Agency (BMA) has consolidated the supervision and regulation of the financial sector (including banks, insurance, and capital markets) under one umbrella. Bahrain is at the forefront in developing Islamic financial services.

2.6 Summary

Liberal trade and investment policies have helped Bahrain to maintain stable economic growth for much of the period since the 1980s and allowed some diversification into non-energy related economic activities. Continued dependence on petroleum resources, however, has resulted in a slowdown in economic growth, particularly during the period 1994-1999 as a result of lower energy prices.

Bahrain is the leading international financial centre in the Gulf region. The financial sector remains one of the main engines of growth for Bahrain's economy and one of the most vibrant in the region. The sector's contribution to the GDP is around 23%, more or less the same share as the oil sector. Banks are profitable, adequately capitalized, and hold high quality assets. To ensure effective supervision and mitigate risks common across the components of the financial sector, the Bahrain Monetary Agency (BMA) has consolidated the supervision and regulation of the financial sector (including banks, insurance, and capital

markets) under one umbrella. Bahrain is at the forefront in developing Islamic financial services.

As a result of the deregulation of the economic system in general and the banking sector in particular, Bahrain hosted two thirds of the Islamic banks operating in GCC countries. These Islamic banks consider Bahrain to be the fountain of their growth. The birth of Islamic banking services in Bahrain dates back to 1978 as already indicated when Bahrain Islamic bank was established to provide commercial banking services. The Islamic banking and finance industry in Bahrain encompasses a unique blend of institutions of different categories.

The Islamic banks in the state of Bahrain have witnessed a revolution in applicable accounting and auditing standards. The BMA obliged Islamic banks and other financial institution to apply International Accounting standards (IAS) from 1992 till 1999. After 1999 the BMA has obliged Islamic banks to apply new accounting standards.

Bahrain has established itself not only as a leading regional international centre for conventional commercial banking and financial activities, but also for Islamic banking operations. The BMA has introduced the first comprehensive prudential and reporting framework that is industry specific to the concepts of Islamic banks and finance. The BMA has also pioneered a range of innovations and new institutions such as the International Islamic Rating Agency (IIRA), General

Council for Islamic Banks and Financial Institutions (GCIBFI), Bahrain Institute of Banking and Finance (BIBF), which are designed to broaden the depth of Islamic financial markets and provide Islamic institutions with wider opportunities to manage their liquidity. For these and other reasons discussed earlier in the chapter, Bahrain was considered an appropriate environment for study.

The following chapter discusses the Islamic banking, their financial reports, Islamic accounting standards and the objectives of Islamic accounting standards. Furthermore the chapter reviews of attitude towards conventional accounting standards.

Chapter Three

Financial reporting for Islamic banking and Islamic accounting standards

3 Introduction

The previous chapter presented the environment where this study has taken place. Bahrain has many positive characteristics recommending it for the study. This chapter discusses the early history of Islamic banking; the basic differences between Islamic banks and conventional banks; and the sources of funds of Islamic banks. This chapter also discusses financial reporting, its objectives, and the differences between the objectives of financial reports for Islamic banks and their counterpart for conventional banks.

Investigating for specific accounting standards consistent with the requirements and objectives of Islamic banks and simultaneously consist with Islamic society and fulfilling the users' needs is one of the main points that are discussed in this chapter. The objectives of Islamic accounting are also discussed in this chapter. This chapter is an attempt to discuss critically the suitability of the conventional accounting standards from western and Islamic viewpoints.

It can be seen that specific Islamic accounting standards can improve many aspects of Islamic finance in general and Islamic banking in particular, to help these organisations to achieve their objectives properly and appropriately within Islamic *Sharia'h* law. Accordingly the chapter supports the need for Islamic accounting standards compliant with Islamic *Sharia'h* law to assist Islamic financial statements users in their decision-making. The succeeding chapter examines this need in more detail.

3.1 Banking in Islam

The need for Islamic banking is driven by three considerations: a) an Islamic investor should avoid association with industries prohibited to Muslims such as alcoholic drinks, gambling, pornography, meat packing (of pork), weapons production; b) an Islamic enterprise should avoid interest (*Riba*), therefore, restrictions exist on trading in debt securities and in the futures markets and options; c) many Muslim investors tend to be attracted to enterprises observing Islamic ethical and moral standards (O'Sullivan, 1996). Islamic banks offer their customers a variety of financial products that do not violate *Sharia'h.* In addition to their role in providing investment and financial activities for Muslims who are keen to adhere to Islamic law in their business transactions, Islamic banks utilise forms of financial instruments, both in mobilising funds for their operations and in providing finance for their customers' operations that comply with the rules and principles of Islamic *Sharia'h* (Archer *et al*, 2001). For mobilising funds from their customers, Islamic banks use a *Mudaraba* contract, which in its original form involved one party contributing capital to a venture while the other party contributed labour. The two parties would share the profits generated by the contract according to a pre-agreed percentage, but in case of loss the capital provider would bear all financial losses, but not more than what had been paid.

For financing activities, Islamic banks utilise either instruments such as *Murabaha*, *Ijarah*, and *Musharaka* etc to cover different areas of banking. Besides the basic financial statements, Islamic banks should disclose issues that are potentially important to the users of such statements but may have a negative effect, such as transactions regarded as unlawful from the Islamic perspective, or provide them with information about the due amount of *Zakat*. Such information may take the form of a board called *Sharia'h* Supervisory Board, which is common within the Islamic banking community. This Board provides the necessary assurance for those who deal with Islamic banks that their religious expectations have been met. Furthermore, the Board's responsibility includes *ex ante* auditing, *ex post* auditing, the calculation of *Zakat*, and advising the bank on its accounting policies (Karim, 1990). The existence of such Board should require finding a suitable regulation to govern the power of *Sharia'h* Supervisory Board and such regulation was not offered by conventional accounting standards bodies. This may entail seeking for specific accounting standards that can govern the Board.

3.1.1 The early history of Islamic banking

In Muslim communities, limited banking activity, such as acceptance of deposits, goes back to the time when the Prophet Mohammed was still alive. At that time, people deposited money with the Prophet or with Abu Baker Sedique (the First *Khalifa* of Islam). Mustafa (1989) says that the first project to put Islamic banking into practice began in the Egyptian delta town Mit-Ghamr in 1962. Within three years, 11 banks had been established with more than a million customers. However, the experiment was dispended in 1967 for political reasons. The first modern Islamic bank, established in Egypt in 1967, was called Nasser's Social Bank. The desirability of abolishing fixed interest rates and the Islamisation of financial systems was discussed at the first meeting of the Islamic Organization Conference (IOC) in Jeddah in 1973. Subsequently, many Islamic banks were founded under the Profit-and-Loss Sharing system (PLS).

The modern Islamic banking has undergone three phases of development:

- Emergence, 1972 through to 1975: this period was marked by a surge in oil revenues and great liquidity. Parallel events included a resurgence of fundamentalist Muslim movements, re-emphasis on the Wahabi School of Brotherhood and Pan-Islamism, and the establishment of IOC.

- Expansion, 1976 to the early 1980s: Islamic banking spread from the Arabian Gulf eastward to Malaysia, and westward to the United Kingdom. 155 Islamic banks were established, including international and intercontinental institutions. Islamic banking associations or consultancy bodies broadened their operations.

- Maturity, 1983 to the present: the Arab world was confronted by economic setbacks, including slowdowns in oil revenues, the collapse of Kuwait's Souk al-Manakh, the relative strength of the U.S. dollar, higher interest rates in the United States, and capital outflows from OPEC nations. At the same time, Arab banks opened branches in the United States and Islamic banking practices were implemented in both Pakistan and Iran.

3.1.2 Definition of Islamic banks

Ainly (1996) questioned "What is Islamic banking?" and found that there seems to be no single definition of what constitutes Islamic banking. The basic principle is, however, clear, namely that making money out of money is contrary to Islamic law. Rather wealth should accumulate from participation in trade and the ownership of real estate. Abdel-Magid (1981) defines the Islamic bank as a shareholding company owned by its shareholders to conduct banking and investment activities in accordance with the Islamic *Sharia'h* and its own articles of association.

The International Association of Islamic Banks (IAIBs) (1995) defines an Islamic bank as those which fall within either one of the two following categories:

- Firstly, an institution which has been established initially to operate within Islamic *Sharia'h* law and restricts its operations to its bounds. These categories have different types of institutions in GCC.
- Secondly, an institution which has been ordained by legislature to shift from a conventional bank to an Islamic bank. This has taken place in three countries: Pakistan, Iran and Sudan.

However, Karim (2001) believes that Islamic banks can be categorised into three groups according to their regulations.

1. The first group has enacted Islamic banking in their laws. This group combined Islamic banks in the following countries; UAE, Iran, Sudan, Yemen, Malaysia, and Turkey. However, the laws of Islamic banking in some of these countries (Malaysia, Iran, Sudan, and Turkey) suggest that they are framed mainly from a commercial banking perspective.
2. The second group has not so far enacted laws to regulate Islamic banking, these banks are in the following countries; Qatar, Saudi Arabia, Egypt, and Jordan.

Islamic banks operate within the laws that govern all the banks in these countries; these laws focus on commercial banking.

3. The third group also has not enacted Islamic banking law but subjected Islamic banking to their fiduciary laws. (e.g. Lebanon). While in all three groups Islamic banks are supervised by the central bank. In some countries (e.g. Kuwait), Islamic banks are supervised by the Ministry of Commerce.

3.1.3 Objectives of Islamic banks

The objectives of Islamic banks are derived from the principle of a socially-oriented function of wealth. Property, and hence money are considered in Islam as a social tool to achieve social goals. Therefore, Islamic banks should structure themselves to serve the community along the lines prescribed by moral values, as well as positive and negative teachings of Islam. Islamic banks do not consider the profitability of the project as the only criterion for investment, it considers also the social output of that project and how this project agrees with Islamic principles. Thus, Islamic banks help in the social security of the country through the *Zakat* fund, *Alqard Al Hassan*, social charity contribution, and also through profit and loss sharing (Mustafa, 1989).

Islamic banks' objectives do not differ from the traditional banks, in general, as their role is to attract the individuals' savings and channel them into different facets of economic activities. Islamic banks emphasise in their objectives the fact that their operation, services, and investments are performed without practicing usury. In addition, providing funds to sectors which are not likely to benefit from conventional banking facilities is one of its stated objectives. Another difference is the source of received funds, which should be from *halal* sources, and the investment of those sources should also be *halal, Sharia'h* requirements should also be applied.

Gambling *et al* (1993) state that the objectives of Islamic banks are as follows:

1. Islamic banks are able and willing to take up the responsibilities of safeguarding humanity from exploitation.
2. Safeguarding humanity from unemployment.
3. Safeguarding humanity from concentrating wealth among a few people.

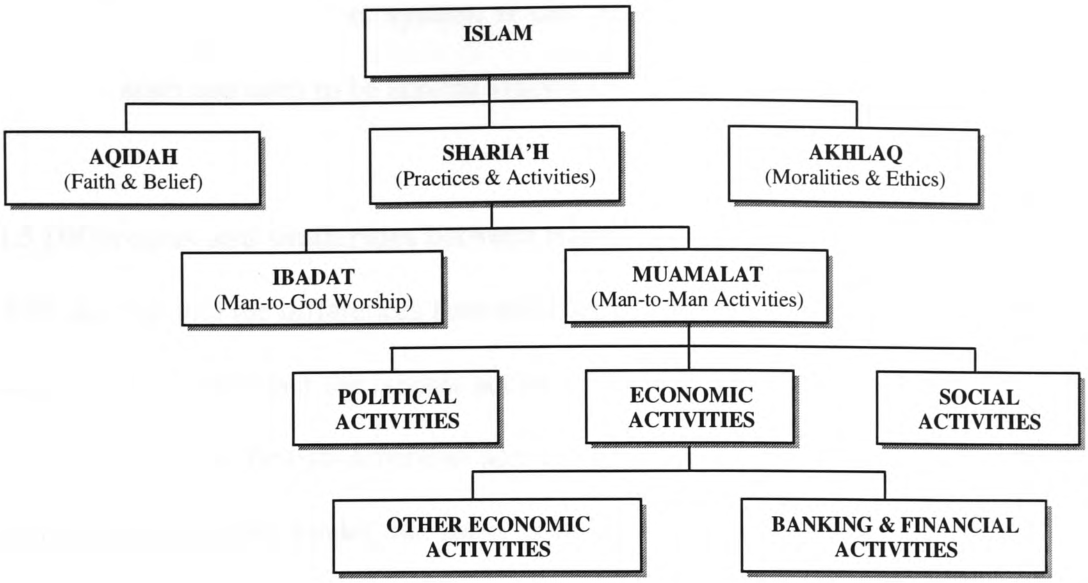
From the above discussion, Islamic banks are an instrument to employ the social surplus funds in the way which can benefit the community as a whole. Islamic banks do not accept investing in any project for the producing of alcoholic drinks to maximise profits because it is prohibited in Islam. Therefore, Islamic banks must deal with products and services which fit with Islamic *Sharia'h* precepts.

3.1.4 The framework of Islamic banking (the *Sharia'h*)

Islamic *Sharia'h* law provides rules that encompass the allocation of resources, management, production, consumption, capital market activity and the distribution of income and wealth. The pioneers of Islamic economic thought developed their idea of carrying on banking business based on Islamic law or, as they become known, Islamic economic principles. The concepts were based on the use of productive (real) investment rather than of monetary investment that attracts interest. Islamic principles allow for the replacement of interest by a return obtained from investment activities and operations finance such as *Murabaha*, *Salam*, *Istisna'a* and *Ijara*, where the return to the financier is linked either to the provision of an asset to the client or to the acquisition of an asset from the client.

The origin and basis of Islamic banking is governed by the *Sharia'h* (Islamic law), sometime referred to as Islamic jurisprudence. The teachings of Islamic economic principles are to develop and to serve Muslims at levels of individual, family, society and state. To appreciate the Islamic concepts of banking and finance, it is essential to place them within the context of the beliefs of the philosophy underlying Islam. Figure 3.1 illustrates the Islamic view of life and the place of banking and financial activities within that framework.

Figure 3.1: The position of banking and finance within Islam



Source: Bahrain Monetary Agency (BMA), 2002, pp.15.

As shown in Figure 3.1, Islam may be perceived as comprising three basic elements: the first is *Aqidah*, which concerns all forms of faith and belief by Muslims in *Allah*. The second is *Sharia'h*, which outlines all forms of practical actions by a Muslim manifesting his faith and belief. The third is *Akhlaq*, which concerns behaviour, attitude, and work ethics within which a Muslim performs his practical action. Accordingly, *Sharia'h* details the practical aspects of a Muslim's daily life. It is divided into two components: *Ibadat* and *Muamalat*. *Ibadat* is concerned with the practice of worshipping *Allah*. *Muamalat* is concerned with the practicalities of mundane daily life in the context of various forms of man-to-man relationship.

One of the significant segments of *Muamalat* is the conduct of a Muslim's economic activities within the economic system. It can be seen that morality and ethics are primary in Islam and need to be applied vigorously in all business matters.

3.1.5 Differences and similarities between Islamic and conventional banks

Before delving into the differences between Islamic banks and conventional banks, it is useful to remember that the Islamic accounting model is based on macroeconomic principles, while the British-American accounting model is based on microeconomic principles. In this latter model, the focus is on the enterprise as an economic entity that affects the economy through its operation in the market (Taheri, 2002).

Islamic banks and conventional banks should not be regarded as a threat. They of course compete with each other, but not usually by the pricing of their services. Instead Islamic banks compete by offering differentiated products that they will appeal to Muslim clients given their *Sharia'h* compliance. Islamic banks, despite being in existence in their modern form for over three decades, are still in many respects an infant industry. The banks themselves lack the critical mass to be more international players. Hence, they need to co-operate with conventional banks to identify alternative financing opportunities and to gain international client appraisal. Islamic banks can draw on expertise in the *Sharia'h*, but they are often lacking in knowledge of sophisticated financing techniques and instruments, and have little experience of financial engineering. In this field co-operation with major international banks can also prove fruitful (Iqbal and Llewelyn, 2002).

The distinct features of the Islamic banks are as follows:

1- The relationship between Islamic banks and their customers is not that of debtors and creditors, or the other way round, but one of participation in risks and reward. This basic assumption lead to the following:

   a) There is no previously fixed return on the funds invested with the bank. Similarly, there is no previously fixed return on funds provided by the Islamic banks. The return is decided, for both sides in the light of the profit realised from the transaction in the ratio of capital participation or agreed ratio of profit–sharing.

   b) There is no liability on the Islamic bank of the *Mudarib* (manager of funds) to the depositor (*Rab al-maal*), except in the case of a current account wherein funds must be returned in full in demand, if the bank has been negligent in investing funds. These funds share profit or loss resulting from the transaction they have been involved in. This is the motivating force that impels the Islamic bank to employ its resources with more prudence and efficiency.

2- Unlike conventional banks which pool together capital funds and investors' funds, an Islamic bank keeps the two segregated. This is so as not to mix the profit earned on its own funds (capital) plus current account balance, repayment of which is guaranteed, with the profit earned on investor's funds, which are accepted on a profit and loss sharing basis. This enables the bank to calculate correctly the profit due to investors.

3- Islamic banks do not provide finance by offering cash loans, as is the case with conventional banks, but through participation financing (*Musharaka*) or through some other form of Islamic instrument like *Murabaha*, *Ijara*, etc. A significant portion of their activities is trading, (i.e. they buy goods needed by their customer against ready cash or on differed payment basis).

4- Islamic banks are multipurpose banks, as they play the role of commercial banks and investment banks. They operate in the short-term like commercial banks, and in the medium and long-term like investment development banks such as Non-Bank Financial Institutions (NBFIs). The organisation depends upon their structure of their resources.

5- While the role of the conventional banks is to attract financial resources and to lend them using interest, so as to make a profit, the emphasis of Islamic bank is to develop the society as a whole. Profit is, no doubt, kept in sight, but that is not the main objective of their financing. The emphasis is on achieving the socio-economic objectives of the society without transgressing the injunction of the *Sharia'h.*

6- Islamic bank is primarily equity-based.

7- Whereas the Islamic system is value-orientated, the conventional system is a value-neutral one.

8- While conventional banks are satisfied with the traditional review by certified auditors, Islamic banks are subjected to additional reviews by the religious supervisory boards to ensure that funds are being raised and invested in ways that conform to Islamic principles.

Furthermore, Khan (2000) stresses that the primary difference between an Islamic bank and a conventional bank is in the treatment of money. In conventional banking, money is a commodity, which can be lent at some pre-determined rate of return (interest), whereas, in Islamic banking, money is a measure of value, which cannot be lent *per se.*

Its organisational structure also varies. The most important differences in this aspect are:

- The *Sharia'h* Supervisory Board which exist in addition to the Board of Directors. An Islamic bank must have the *Sharia'h* Supervisory Board, or

Committee, which is composed of religious authorities, including those with a detailed knowledge of *Sharia'h* law so that they can ensure all bank practices confirm with the letter as well as the spirit of Islamic teaching (Wilson, 1985).

- The Legal Department. The existence of a legal department is essential for drawing up agreements and contracts based on *Sharia'h* law. The department's primary goal is to protect the bank in the event of any dispute between the bank and its customers where the existing countries may be unable to act (Presley, 1988).

- The Follow-up Department. This department may be part or separate from the marketing department. Its main goal is to monitor and appraise a project once the bank has executed the documentation and transferred the capital to the client.

- The Social Department. One of the objectives of this department is to help charitable organisations by providing them with financial aid. It also distributes *Zakat* which the bank must pay as a percentage (2.5%) on its capital and profits every financial year to those in need of financial assistance.

Islamic banks can however learn from the experience of conventional banks in information technology and conventional banks can learn from Islamic banks new facets of relationship banking and how to achieve client loyalty by the convergence of banking and customer values. Islamic banks dealing with conventional banks need to ensure that any cash or portfolio management is conducted in accordance with the *Sharia'h*. Nevertheless, the last two decades have demonstrated that conventional banks can legitimately offer Islamic financing facilities. There would seem to be many promising areas for co-operation between Islamic banks and conventional banks but, this does not mean that both types of institutions will not continue to complement each other.

Although most of the remaining departments, such as the marketing department, credit departments, the human resource department, investment departments, and so on, are identical to those of a conventional bank, there are a few that vary slightly. The credit and marketing department is one of the eight subsets of management controllable variables.

3.1.6 Sources of funds (funding operations) of Islamic banks

1. Capital and real estate: the main shareholders of many Islamic banks are influential individuals and/or governments of Arab states. Authorized capital is paid in according to local government regulations. Only common stock may be issued.

2. Investment deposits: the deposits (saving accounts, fixed-term deposits, and unlimited term deposits) are invested on the basis of the PLS system. Depositors not only participate in profits, but may also lose, in some cases, the entire deposit.

3. Current account deposits: these deposits, which are not used for investment, are held for transaction and contingency purposes. While depositors do not receive any remuneration, they are provided with checking facilities, overdraft privileges, and other defined services.

4. *Zakat* fund: *Zakat* is a levy like tax collected by an Islamic bank from its shareholders, depositors, employees, and other parties by applying principles based on *Sharia'h* law.

The Islamic financial institutions in general and Islamic banks in particular should seek to abide by *Sharia'h* precepts in setting their accounting standards. The objective of Islamic accounting would be to provide information to society about the discharge of the account's trust to *Allah* and to society in order to establish justice and solidarity among members of the society and to avoid disputes among members through transparency of the operations of the organisation. It is also essential for Islamic banks to have an accounting system that is sufficient to accommodate for the tax-bases on which *Zakat* should be paid.

3.2 Financial reports

Harahap (2001) defines financial statements (or annual reports) as a report that allows management to communicate the financial condition of their organisation, the result of operations, and other information to interested parties. Accordingly, any firm should issue annual reports in order to distribute its financial statements and communicate other relevant information to shareholders and others outside of the business. As these users have no direct access to the accounting records, they must depend on the information contained in these reports. Beyond the financial statements and accompanying notes and text, management must devise its own method to help the users to understand data in the statements. On the other hand, the annual reports that the firm should present to the users should disclose the accounting standards on which the statements are based.

Al-Hajji (2003), states that the financial reports should disclose information of a quantitative and qualitative nature. Quantitative information involves the collection of numerical data concerned with costs incurred, quantities produced, resources used, and revenue generated. Qualitative information meanwhile comprises some form of commentary or other information on the performance of the entity. AAOIFI (2002) defines the basic elements of financial statements which consist of a statement of financial position, income statements, statements of changes in owners equity or statements of retained earnings, statements of cash flows, statements of changes in restricted investments and their equivalent, statement of sources and users of funds in *Zakat* and charity funds, and lastly, statements of sources of *Alqard Alhassan* fund.

As can be seen from the above definition, the main task of the annual report is to convey information from the preparers to the users about the performance of the entity or about their relationship with the entity to help them in decision-making.

3.2.1 Objectives of financial reports for Islamic banks

Seif (2004) states that the objective of financial reports are to provide the following kinds of information:

1. Information about the Islamic bank's objectives and the extent of its compliance with *Sharia'h.* And if the bank is partly engaged in prohibited dealings, information about the separation of such dealings and how to dispose of them.

2. Financial information assisting users to evaluate the adequacy of the Islamic bank's capital, risks inherent in investment, and the degree of liquidity for meeting the outstanding obligations.

3. Information to assist in the assessment of *Zakat* on the Islamic bank's funds and the targets of its disposal.

4. Information about cash flows, their timing, and associated risks. This will help users evaluate an Islamic bank's ability to generate sufficient dividend income for equity and profit for investment holders.

5. Information to assist in evaluating the Islamic bank's discharge of its fiduciary responsibility, to safeguard funds and invest them at a reasonable rate of return. This includes information about investment rates of return on the bank's investment and the rates of return accruing to equity and investment holders.

Furthermore, AAOIFI (2002) states that the financial reports which are directed mainly to external users should provide the following types of information:

a) Information about Islamic bank's compliance with the Islamic *Sharia'h* and its objectives and to establish such compliance and information outlining the separation of prohibited earnings and expenditure, if any, which occurred, and of the manner in which these were deposed of.

b) Information about Islamic bank's economic resources and related obligations (the obligations of the Islamic banks to transfer economic resources to satisfy the rights of its owners or the rights of others), and the effect of transactions, other events and circumstances relating to the entity's economic resources and associated obligations. This information should be directed principally at assisting the user to evaluate the adequacy of Islamic bank's capital to absorb losses and business risks; to assess the risk inherent in its investments and; to evaluate the degree of liquidity of its assets and the liquidity requirements for meeting its other obligations.

c) Information to assist the concerned party in the determination of *Zakat* on the Islamic bank's funds and the purpose for which it will be disbursed.

d) Information to assist in estimating cash flows that might be realised from dealing with the Islamic bank, the timing of those flows and the risk associated with their realisation. This information should be directed principally at assisting the user to evaluate the Islamic bank's ability to generate income and to convert it into cash flows for distributing profits to equity and investment account holders.

e) Information to assist in evaluating the Islamic bank's discharge of its fiduciary responsibility to safeguard funds and to invest them at reasonable rates of return, and information about investment rates of returns on the banks investments and the rate of return dischargeable to equity and investment account holders.

f) Information about the Islamic bank's discharge of its social responsibilities.

Banking success, in general, depends on the extent of public trust placed in the financial strength of individual banks. Trust in Islamic banks relates to the extent of adherence to *Sharia'h*. On the other hand, one major source of public confidence is the quality of information issued to the investing public about the bank's ability to achieve both financial and *Sharia'h*-related objectives.

3.2.2 Differences between the objectives of financial reports for Islamic banks and their counterpart conventional banks

Besides those statements and reports deemed to be traditional, Islamic banks should publish the following financial reports:

1. The *Sharia'h* Supervisory Board report about their duty of directing, reviewing and supervising the activities of Islamic banks in order to ensure that they are in compliance with Islamic *Sharia'h* rules and principles.

2. Analytical financial report about earning or expenditure prohibited by the *Sharia'h*. It is important for the financial statements to disclose income earned by the Islamic bank from prohibited transactions or sources and expenditures prohibited by *Sharia'h* and how those earnings are disposed of. To satisfy the interest of those who use the financial statements, such a report may include information about the causes of earnings, their sources, how they are disposed of and the procedure established to prevent entering into transactions prohibited by the *Sharia'h*.

3. Analytical financial report about sources of funds for *Zakat* and their uses. Although the financial statements of Islamic banks discuss the liability for *Zakat*

and the amount that has been disbursed, users of financial statements might be interested in an additional analysis of sources of funds for *Zakat* and methods of its collection including controls to safeguard these funds and their uses.

4. Report concerning the Islamic bank's fulfilment of its social responsibilities. Islam has always been concerned with the concept of social responsibility whether that responsibility is for the welfare of society or the prevention of harm. Indeed, this can be clearly observed in the *Qur'an* verses and the sayings and deeds of the prophet (peace be upon him). For example *Allah* said "but seek with the (wealth) which *Allah* has bestowed on thee, the home of the hereafter, nor forget thy portion in this world: but do thou good as *Allah* has been good to thee and seek not (occasions for) mischief in the land". (Chapter 28: verse 77). The prophet (peace be upon him) said "the most loved by *Allah* among the people are those helpful to others". This shows that Islam spearheaded this concept which has not reached prominence in the West until relatively recently.

5. Report about the development of the Islamic bank's human resources. Those reports may contain information about the bank's effort to develop the human resources whether with respect to their knowledge of *Sharia'h* or economics. In addition it would include the bank's effort in encouraging its employees to be effective and efficient.

6. Report about changes in restricted investment and their equivalent. The basic element of this statement includes restricted investments as of a given date, deposits and withdrawals by holders of restricted investment accounts and their equivalent, restricted investment profits and losses before the investment manager share in investment profits as a *Mudarib* or his compensation as an investment agent, and the investment profits or compensation during the period at that date (AAOIFI, 2002 para. 50).

There are differences between the objectives of financial reports for Islamic banks and conventional banks. These differences are summarised as follows:

1- Islamic banks must comply with the principles and rules of *Sharia'h* in all their financial and other dealings.

2- The functions of Islamic banks are significantly different from those of traditional banks who have adopted the Western model of banking.

3- The relationship between Islamic banks and the parties that deal with them differs from the relationship of those who deal with traditional banks. Unlike traditional banks, Islamic banks do not use interest in their investment and financing transactions, whereas traditional banks borrow and lend money on the governing principle of return of interest. Islamic banks mobilise funds through investment accounts on the basis of *Mudaraba* (i.e. sharing of profit between the investor who provides the funds on the bases of *Mudaraba*, profit and loss sharing mechanisms, or deferred payments methods consistent with the *Sharia'h*).

Due to the structure of Islamic banks and the nature of their objectives, financial reports of Islamic banks should interpret their actions which in many aspects are different to traditional banks. These differences between Islamic banks and conventional banks require different accounting standards. However, accounting standards developed for traditional banks may not be relevant to Islamic banks. Nevertheless, when developing accounting standards for Islamic banks, the AAOIFI board may be guided by clear objectives and concepts which are appropriate for other banks that are not in compliance with the *Sharia'h* precepts.

3.3 Islamic accounting standards

Accounting, whether in the Western or Islamic world, provides information for investors, creditors, managers, governments and the public in general to judge and evaluate the deployment and use of scarce resources. It also provides management with the necessary information to explain its progress toward achieving its strategic objectives (Idris, 1996). Accounting principles have been evolved over time to meet contemporary needs for information by internal and external users, thus the advantage of having a conceptual framework which is more likely to establish confidence among accounting information users.

However, many aspects of the Islamic economy differ greatly from Western economies. Anglo-American accounting techniques cannot be readily applied in Islamic economies and thus, international accounting standards based on such techniques create difficulties for Muslims around the world. Most of the accounting rules in the majority of Muslim countries are the result of direct foreign influence. Many factors have influenced the development of accounting in Muslim countries in the form of economic, legal, political, sociological, and technological consideration which are no different from their counterparts in the Western world.

The Islamic economic system while not yet fully implemented has established Islamic banks and *Zakat* institutions. These pioneer institutions, in many cases, are operating under Western law, capitalistic markets and Anglo-American accounting rules. Hence, in common, with the conditions in other developing countries, there is a mismatch between the goals of the system and the imported accounting concepts and standards (Hove and Fandaidza, 1986). However, Islam has many universal values in common with the West, but the specific prohibition of interest and establishment of the *Zakat*, the rule of law on gambling and uncertain contracts etc. are prohibited. Therefore, this implies that the objectives of accounting in Islam are different from conventional accounting and even the objectives of social and environmental accounting may differ to a certain extent (Idris, 1996).

The emergence of Islamic banks and other Islamic financial institutions in the Middle East and other parts of the world has brought forward the issue of their relationship with the regulatory bodies. Most Islamic financial institutions have adopted their accounting standards from local accounting authorities or those of the International Accounting Standards Committee (IASC) in preparing their accounting reports. Among the members of the IASC Muslim countries are Bahrain, Bangladesh, Egypt, Indonesia, Iraq, Jordan, Lebanon, Malaysia, Nigeria, Pakistan, Syria, Tunisia, and Turkey (IASC, 1994). This has been outlined by Karim (2001), who adds that, the applying of IASC standards as their national standards, or developed national accounting standards based on it, render the financial statements of these institutions non-comparable.

This coincides with Karim's opinion in another article which states that the structure and the process of Islamic banks do not readily fit in with those of conventional universal banking which combines commercial and investment businesses (Karim, 2001). He argues that it seems to have resulted in supervisory bodies adopting different approaches to regulate Islamic banking and such variations in the regulation of Islamic banking appear in turn to have resulted in Islamic banks adopting different accounting treatments for the same transaction.

The early papers on Islamic accounting concentrated on the accounting problems of Islamic banks and dealt mostly with the applicability of conventional accounting principles to Islamic institutions, for example; Gambling and Karim (1991), and Abdel-Magid, (1981). However, some authors state that adopting conventional accounting principles to be in line with Islamic accounting principles is an acceptable practice. Abdelgader (1994), for example, states that although Islamic banks operate in a different way from conventional banks that does not mean they are totally different financial institutions which need entirely different accounting standards.

A survey of research in Islamic accounting by Adnan and Gaffikin (1997) found that most of the authors, expertises and practitioners are significantly influenced by Western accounting thought. Consequently, when they try to suggest an accounting concept from an Islamic viewpoint, they substantially still adhere to the values inherent in Western accounting philosophy and as a consequence, many view that all conventional or Western accounting concepts can be applied to Islamic banks and, should an adjustment be made, it will be limited to technical rather than conceptual issues. Zaid (1997) began a series of conferences on the "Islamic Perspective on Accounting, Finance and Commerce" starting with the first international conference in Sydney in 1997.

One of the earliest writing in this area is Karim and Gambling (1986). They examined and compared western and Islamic ethics and philosophy and their accounting implications. Karim (1990) further calls Islamic banks to take the initiative to self-regulate their financial reporting, otherwise the local authority may intervene and legislate the accounting policies of Islamic banks. He also assumed that the only way that the AAOIFI could fully implement its promulgated standards was by depending on the co-operation of the national banking regulators. Karim (1990) states that most countries, in which Islamic banks operate, look directly to IAS standards as their national standards or develop national standards based primarily on IAS. He states that this rendered the financial statements of Islamic banks non-comparable.

Karim has published several articles which discuss the need for alternative accounting standards that are more relevant, reliable, and give confidence and trust to the users of financial statements and are based on the Islamic *Sharia'h* law (Karim 1995, Gambling and Karim 1986, and 1993). These papers discuss various aspects of Islamic accounting, including the conceptual framework for financial reporting for Islamic banks, standards setting for Islamic banks, Islamic and social accounting (which unfortunately is not a proper academic study of the relationships between social accounting and Islam). Karim is also responsible for setting accounting standards for Islamic banks which are by themselves a great advance in the theory and practice of Islamic accounting. Karim (2001) also stresses the growing need for accounting standards and indicates that the AAOIFI's regulatory effort has been focusing on certain Islamic investment vehicles.

Khan (1994) discusses the relationship between accounting and society, the accounting information needs of an Islamic society, the accounting issues in an Islamic framework, limited liability and valuation issues, etc. Khan has elaborated upon the most important issues of Islamic accounting, not only those relevant for banks. This work provides an agenda for further research in specific areas of Islamic accounting.

Meanwhile, Taheri (2002) argues that cultural, social, economical, and political factors have considerable effects on the kind of financial statements to be provided. However, these factors are not similar in all countries and each country uses an accounting system, which fits its own specifications. Therefore, he concludes that:

"Without application of *Sharia'h* Islamia'h, the setting of Islamic Accounting Standards is impossible. Elements which should be considered include: Islamic economy elements; the most important of which is social justice through application of the prohibition of *Riba*, *Zakat*, and Islamic ethics. Other factors such as environmental and international elements which influence the Muslim community and adoption of these elements are possible based on *Ejtihad* (see glossary) through application of "Time" and "Place".

However, Haqiqi and Pomeranz (1987) conclude that one of the main problems facing Islamic banking is the absence of accounting (and auditing) standards pertinent to Islamic banks. Uncertainty in accounting principles involves revenue realisation, disclosures of accounting information, accounting bases, valuation, revenue and expense matching etc. Thus, the results of Islamic banking schemes may not be adequately defined, particularly profit and loss shares attributed to depositors. They also state other reasons to justify the lack of uniform standards of credit analysis including the fact that Islamic banks have no appropriate standard of credit analysis, especially for Profit and Loss Sharing (PLS) schemes. Similarly, there is a widespread training need involving related aspects such as financial feasibility studies, monitoring of ventures, and portfolio evaluation. Haqiqi (1987) co-authored recommendations for; (a) establishment of Islamic bank accounting standards, (b) a focus on auditing possibly before tackling accounting, (c) conformity of new rules to Islamic and Arab social and religious objectives, and (d) a co-ordinated and unified approach to the interpretation of pertinent Islamic law.

O'Sullivan (1996) states that the AAOIFI sought implementation of its rules partly by asking central banks to adopt them and partly by trying to persuade Islamic institutions of their usefulness. Errico and Farahbaksh (1998) note that until now the issue that standards used for conventional banks should apply to Islamic banks has received little attention, even in countries where all banks follow Islamic principles.

Furthermore, they argue that a number of standards and best practices established by the "Basle Committee on Banking Supervision" are not always applicable (as they stand) to Islamic banking. An appropriate regulatory framework governing Islamic banks needs to place greater emphasis on the management of operational risks and information disclosure issues than is normally the case in conventional banking.

According to Khalid (1995) who state that there are no generally accepted guidelines on which central banks, in the countries in which Islamic banks operate, would base the treatment of profit sharing investment accounts for the purpose of calculating the capital adequacy ratio for these banks. There is also a lack of consensus about the guidelines on the liquidity requirements of Islamic banks. Khalid (1995, p. 125) argues that:

"... the conceptual difference which gives rise to different liquidity ratios between an Islamic bank and a conventional bank is that for a conventional bank, all its deposits represent its direct liability to the depositors. The same is true for an Islamic bank, but only in the case of deposits in the current and savings accounts. In the case of general investment accounts and special investment accounts, the Islamic bank does not borrow or guarantee the fund."

From the above, it can be seen that the Islam has many universal values in common with the traditional norm. Therefore, there is a need for an Islamic accounting based on the following premises:

- Accounting is a social construct. Conventional accounting has developed according to the needs of the capitalistic Western society and it can only by justified in a pristine liberal economic democracy. Its underlying assumptions are wealth maximisation and utility maximising and self-interest. Muslim society is (or ought to be) different from Western society, because it is based on "Divine Guidance and *Sharia'h*" with a different outlook on life and different motivation i.e. to please *Allah* by doing what he commands and refraining from what he forbids. *Allah* is not pleased with selfish profit-maximisation.

- Wealth maximisation does not lead to social welfare as defined by Islam. Thus Islamic accounting must have a different objective. Social welfare in Islam means avoidance of disputes, co-operation, solidarity, equitable distribution of income and wealth along with spiritual endeavours.

- Conventional accounting leads to global ecological destruction and ultimately human destruction because its consumption patterns are not sustainable. Islam has a specific prohibition on cruelty to animals and plant life and conservation of resources (e.g. water). Thus, a system which encourages destruction and waste cannot be followed.

➢ Western accounting is an information system, which by impacting on human behaviour leads to concentration of wealth and power exists within a neo pluralistic society and reveals wide disparities of income and wealth distribution leading to a basically unstable society. Any Islamic accounting should not lead to such behaviour which is the very antithesis of the *Sharia'h*.

Furthermore, Hameed and Ibrahim (1999) stress that conventional accounting is unsuitable for an Islamic society because it embraces fundamental values and principles which are in conflict with Islamic values. Thus, adopting or even modifying conventional accounting concepts is insufficient to develop an accounting system which provides information that will lead to behaviour consistent with Islamic norms and towards Islamic objectives. In addition, the establishment of Islamic organizations in many Muslim countries with their stated Islamic objectives reinforces the need for Islamic accounting. There is a need therefore to develop an alternative accounting system which induces the behaviour and actions that enables the fulfilment of the objectives of that society. To coincide with this, Khan (1994) states that there is a need for accounting information in Islamic society, besides recording and reporting profitability, liquidity, solvency, and efficiency. In addition, the following should be reported:

- The true figure of *Zakat* payable and in the accounts of *Zakat* administration agencies, the collections, distribution and impact of *Zakat*.

- The extent to which justice and benevolence is considered in the organisation's treatment of its employees.
- The extent to which the business keeps the promises and fulfil its contracts
- The impact of the business on its environment.
- The extent to which the business adheres to the Islamic code of business ethics while dealing with customers, competitors, government and other agencies; and
- The contribution of the business toward the socioeconomic development of society.

In addition, accounting information should provide information on *Sharia'h* compliance, report the prohibition transactions, and the disposal of income gained from such transactions and act according to the *ex*-auditing contracts drawn up by *Sharia'h* board members.

Hove and Fandaidza (1986) describes the influence of traditional accounting as the legacy of inappropriate technologies. Wallace (1990) also questions the international harmonisation of accounting standards and sees this as an attempt by the big eight (now the big six) and other international accounting firms to expand their influence and hegemony over the developing countries. However, Taheri (2002) takes the view that an Islamic accounting model is based on macroeconomics, while the British-American accounting model is based on microeconomics. In this latter model, the focus is on the enterprise as an economic entity that affects the economy through its operations in the market. He further summarized the similarities and differences of accounting elements in standard setting for an Islamic accounting model versus a British-American model as following;

Table 4.1: Islamic accounting versus Britisb-American model

Elements	British-American model	An Islamic model
Economic approach	Micro	Macro
Primary users	Investors and Creditors	State, Management, People
Accounting policy	Goal oriented	Value oriented
Asset valuation	Historical cost price	Current exit price
Income determination	Revenue-expense approach	Asset-liability approach
Time value money	Yes	No
Time period	Yes	Yes
Primary focus	Income statement	Balance sheet
Theoretical concept	Entity theory	Proprietary theory
Fixed interest	Yes	No
Legalistic orientation	Common law	Religious law

Source: Taheri (2002), p. 15.

He adds that the objective of Islamic accounting would be to provide information to society about the discharge of the account's trust to *Allah* and to society in order to establish justice and solidarity among members of the society (which includes the environment) and to avoid disputes among members through transparency of the operations of the organisation. The information should be used to enhance efficiency, reduce waste and the deterioration of the environment, promote and ensure only Islamically permitted economic activities ensuring socio-economic justice is carried out and finally, the information should help the equitable distribution of wealth among all sections of society.

Therefore, the Islamic financial institutions in general and Islamic banks in particular should seek to abide by *Sharia'h* precepts in setting their accounting standards. In order to fulfil this, the Islamic banks and other financial institutions should be asked to implement AAOIFI's standards, as is currently the case in some countries. This would render the financial statements of these financial organisations more comparable, because AAOIFI standards are specifically developed to cater for the unique characteristics of the *Sharia'h* contract that govern the Islamic financial instruments.

3.4 Objectives of Islamic financial accounting

To issue reliable and relevant financial information, accounting standards for Islamic banks should be developed consistently in relation to the unique objectives of financial accounting for Islamic banks. Further, for the need to ensure consistency among present and future accounting standards, Islamic objectives have to be clearly specified. The setting of clear objectives for Islamic financial institutions will also assist Islamic banks in making a sensible accounting choice. The objectives of financial accounting determine the type and nature of information which should be included in the financial reports in order to assist users of these reports in decision-making. Government agencies have the power to obtain the type of information that serves their needs. This leaves other users of information limited to the common information contained in the financial reports of Islamic banks; namely equity holders, investment account holders, current and saving account holders, other depositors, other dealers with Islamic banks, *Zakat* agencies, and regulatory agencies. Consequently, Seif (2004) states that the objectives of Islamic financial accounting for Islamic banks and institutions are to achieve the following:

1. Determine the rights and obligations of all interested parties, including rights and obligations resulting from incomplete transactions and other events in accordance with the principles of *Sharia'h* and its concepts of fairness, clarity and business ethics.

2. Subscribe to the safeguarding of the assets of the Islamic bank, the rights of Islamic banks and the rights of others in an adequate manner.

3. Subscribe to the enhancement of management and the productive capabilities of the Islamic bank and encourage compliance with the established goals and policies, and above all Islamic *Sharia'h*, in all transactions and events.

4. Provide financial reports containing useful information to report to users to enable them to make legitimate decisions in their dealing with Islamic banks.

However, Hameed Rizal (2003) discusses the objectives of Islamic accounting from a different angle. They propose the following objectives: (1) decision usefulness, (2) stewardship, (3) Islamic accountability and (4) accountability through *Zakat*.

3.4.1 Decision Usefulness

This objective is proposed by the AAOIFI for the Islamic banks. The AAOIFI (1996) in its Statement of Financial Accounting (SFA) No.1, recognized that the objectives of financial accounting determine the type and the nature of information which should be included in financial reports in order to assist users of these reports in decision-making (SFA para 25). Therefore, financial reports should provide information which is useful for users, such as; (a) Information about the Islamic bank's compliance with the Islamic *Sharia'h* (SFA para 37); (b) Information about the economic resources and obligations and the effect of transactions, other events and circumstances and related obligations (SFA para 38); (c) Information to assist the concerned party in the determination of *Zakat* on the fund (SFA para 39); (d) Information to assist in estimating cash flows that might be realized from dealing with the Islamic bank, the timing of those flows and the risk associated with their realization (SFA para 40); (e) Information to assist in evaluating the Islamic bank's discharge of its fiduciary responsibility to safeguard funds and to invest them (SFA para 41); and (f) Information about the Islamic bank's discharge of its social responsibility (SFA para 42).

However Hameed and Rizal (2003) argues that, despite listing other objectives which are Islamically inclined, the underlying framework of AAOIFI's conceptual framework seems to be in line with those currently being practiced in conventional accounting. For example, the Statement of Financial Accounting Concepts (SFAC) No.1 issued by the Financial Accounting Standard Board (FASB) in the United States states that the financial report should provide useful information to present to potential investors and creditors and other users to assist them in making rational investment, credit and similar decisions (SFAC para 34). This is evidenced by the fact that SFA-AAOIFI No.1 paragraph 25, mentions the role of financial reporting in the economy is to provide information that is useful in making business and economic decisions.

It seems to be both the AAOIFI and the FASB accept the traditional view that relevant information for users is information about the company's financial position and performance. Financial performance has to do with how successful a firm is in achieving its overall goal which is assumed to be the making of profit (Kam, 1990). Therefore, financial performance is directly linked to profitability. Accordingly, greater profitability equates to a greater achievement for any particular company.
Henderson and Peirson (1988) assert that decision usefulness can be extended to include the needs of those parties who seek to exercise an overview or monitoring role over the social performance of the corporation. However, most of the literature

on decision usefulness relates only to the needs of shareholders and creditors (Kam, 1990). Therefore, useful information is mainly associated with the ability to predict when the investor will receive dividends and the amount involved (or how much they would receive if they want to sell their shares) and the ability to know if the company is able to pay a creditor's loan (or how much they will receive if they were to sell or redeem their bonds). Since naturally the investors and creditors hope that their cash receipts will exceed their cash outlays, the company then is directed towards increasing its ability to generate favourable cash flows (Kam, 1990). In this case, decision usefulness is a suitable objective in supporting an organization to achieve such goals.

3.4.2 Stewardship

Stewardship accounting has been practiced since ancient times and was particularly important at that time to establish the credibility of their tenant to the often-absent landlord (Mathews and Pereira, 1996). Chen (1975) notes that the concept of stewardship has arose from religious teachings. For instance, a Christian, in thanks for the resources given to him is a steward of God. Man as God's steward owes a responsibility to use property effectively not only for himself but also as a social responsibility for others around him. This concept developed in the feudal version of stewardship where resources, especially lands were given up to be managed on the landlord's behalf. Here the serf was responsible for taking care of the land for the landlord whereas the landlord had to discharge his social responsibility for the serfs and his family.

Since the middle of the nineteenth century, the concept of stewardship in accounting has referred to the separation of ownership and capital, which resulted from the development of the joint stock company structure. At this time, the model of classical stewardship took on a radically different ideology. The managers who were servants of the capital providers recognized only stewardship to their masters and ignored their social responsibility (Chen, 1975). Meanwhile, the financial statement became a way of demonstrating that the resources entrusted to management had been used in a proper manner. In terms of external reporting, the emphasis of stewardship is on showing that investments have been made in productive assets in an attempt to meet the organization's objectives. This requires a balance sheet and profit and loss accounts so that owners can trace aggregate financial movements during a certain period (Mathews and Pereira, 1996).

The current stewardship concept is quite close to the decision usefulness concept, but is not adequate to meet its needs fully. This is because in stewardship (1) potential investors and creditors are not included as users; (2) it is not intended for the prediction model of users and (3) it mainly looks at the past to see what has been accomplished (Mathews and Pereira, 1996).

AAOIFI (1996) recognizes stewardship as one of its objectives. It states that the objective of financial accounting is to contribute to the safeguarding of the assets, and to the enhancement of the managerial and productive capabilities of the Islamic bank while encouraging compliance with its established goals and policies (SFA para 33 – 34). Mirza and Baydoun (2000) support this objective and suggest that the stewardship function must be the focus of attention of accountants of Islamic institutions in reporting to external parties.

Meanwhile, SFAC-FASB No. 1 also suggests that financial reporting should provide information about how the management of an enterprise has discharged its stewardship to shareholders for the use of the enterprise resources entrusted. The stewardship is maintained not only in the supervision and safekeeping of resources but also for their efficient and profitable use and for protecting them to the greatest extent possible from an unfavourable economic impact such as inflation, deflation and technological and social changes (SFAC para 50).

3.4.3 Accountability

Gray *et al* (1996) define accountability as the duty to provide an account or calculation or record of those actions for which one is held responsible. Accountability is said to be a broader concept than stewardship. This definition takes accountability as a form of principal agent relationship. In this form, an Accountee (chief) enters into a contractual relationship with an Accountor (agent). The Accountee gives the power over resources along with instructions about actions and rewards to the Accountor. On the other hand, the Accountor is supposed to take certain actions and refrain from others in managing the resources given to him to meet certain objectives and to account to his principal by laying bare all his actions.

However, Hameed (2000b) extends accountability to undertake (or to refrain from) certain actions and to provide an account of these actions as mentioned by Gray *et al* (1996). He adds a metaphysical dimension of accountability to God, discharged through accountability to society. He also suggests that Islamic accountability can be regarded as the primary objective of Islamic accounting. Furthermore, other kinds of accountability objectives are also proposed as the primary objective of Islamic accounting. This type of accountability is based on *Zakat* obligation (Adnan and Gaffikin, 1997). The following section discusses each of these suggestions.

3.4.3.1 Islamic Accountability

Hameed (2000b) starts his argument on Islamic accountability with Faruqi's (1992) description of the concept of *Khilafa* (vice-gerent). This concept explains the vice-gerent status of man in the world, in which *Allah* (God Almighty) has given trust of the earth to man (*Al-Qur'an* 35:39) while other creatures including angels, animals and non living matter have no ability to undertake its stewardship. As stated in the

Holy *Qur'an*, "*Allah* indeed has offered the trust to the Heavens and Earth and the Mountains, but they refused to undertake it being afraid thereof but man undertook it" (*Al-Qur'an* 33:72). This trust is such a heavy responsibility that even the Heavens, the Earth and the Mountains did not feel prepared to bear it, while man is the one who accepted the trust.

Therefore, man should undertake his duty since this will be accounted for. Man is not only accountable for the spiritual aspects but also for social, business and contractual dealings as *Allah* also commands man to give things that have been entrusted back to whom they are due (*Al-Qur'an* 4:58). This command then is detailed in another verse of the *Qur'an* that "man should fulfil (every contract) because (every) contract will be questioned (on the day of the judgment)" (*Al-Qur'an* 17:34).

Hameed (2000b) suggests that this kind of accountability can be used as the main objective of Islamic accounting which he then names Islamic accountability. This suggestion is also supported by Khir (1992) who asserts that this concept is so ingrained in the Muslim community that it will give the greatest motivation for the practical development of Islamic accounting. Islamic accountability as explained by Hameed (2000b) is premised on both the accountor (Islamic/Muslim organizations) and the accountee (owners) having dual accountabilities. The first or prime accountability arises through the concept of *Khilafa* whereby a man is a trustee of

Allah's resources. This primary accountability is transcendent as it cannot be perceived through the senses. However, it is made visible through the revelation of the *Qur'an* and *Hades*, which are the main sources of Islamic teachings.

Meanwhile, the secondary accountability is established by a contract between an owner or investor and a manager. To discharge both the primary and the secondary accountabilities, the company should identify, measure, and report the socio-economic activities pertaining to Islamic social economic and environmental issues. Further, based on Islamic accountability, subsidiary objectivities can be determined such as *Sharia'h* compliance, assessment and distribution of *Zakat* and equitable distribution of wealth among stakeholders. The creation of a co-operative environment and solidarity and other type of reports can contribute in providing information and encouraging the enterprise to participate in solving contemporary social problems (Hameed, 2000b).

3.4.3.2 Accountability through *Zakat*

Adnan and Gaffikin (1997) assert that one of the primary objectives of Islamic accounting information is the provision of information to satisfy an accountability obligation to the real owner (*Allah*). Therefore, the overall accountability will be better operationalized if it is directed towards the fulfilment of the *Zakat* obligation. They argue that by making *Zakat*, the primary objective, the unwanted practice of cheating or window-dressing is largely avoided as he or she believes that *Allah* always watches him or her. Consequently, accounting information will indirectly fulfil its users' needs as well as its social responsibility (Adnan and Gaffikin, 1997).

Triyuwono (2000) suggests that Muslim organizations should be *Zakat* oriented instead of profit oriented as they are now. This means that the net profit is no longer used as a basis of performance measurement as it is replaced by *Zakat* orientation. Therefore, an enterprise is directed to the achievement of higher *Zakat* payment. To achieve a *Zakat* oriented enterprise, it is necessary to maintain a *Zakat* oriented accounting system. Triyuwono (2000) believes that the use of *Zakat* oriented accounting would result in a more Islamic organization as it implies certain features. First, it is transformed from profit maximization to *Zakat* maximization. Profit is only regarded as an intermediary goal while *Zakat* is the primary goal. Second, since *Zakat* has been taken as the ultimate goal, any activity policy of the enterprise must comply with the Islamic *Sharia'h*. Third, it would inherently incorporate a balance between individual character and social character. This is because the *Zakat* concept encourages Muslims to make profits (under *Sharia'h* guidance) and to distribute some of the profit (fixed percentage) as *Zakat* to fulfil one's concern for social welfare. Fourth, the enterprise would be encouraged to participate in releasing humanity from the oppression of economic, social and intellectual factors and releasing the environment from human exploitation. Fifth, it provides a bridge between the world and the Hereafter as *Zakat* raises the human awareness that any worldly activities are related with their destiny in the Hereafter.

Therefore, putting *Zakat* as the ultimate objective would entail narrowing the Islamic view on economic issues. However, there is no doubt that the *Zakat*, as one of the main pillars in Islam, should be upheld. It is too simplistic to say that *Zakat* would solve all the economic problems. In fact, Islamic socio-economic objectives involve a wide range of concerns and *Zakat* is only one of the main instruments employed to achieve such objectives.

Therefore, the Islamic system in business in general and banking in particular should be able to achieve the objectives of the Islamic teachings, which include everything that is needed to realize success in the world and the Hereafter and make a good life for humanity within the constraints of the Islamic *Sharia'h.*

3.5 Review of the attitude towards conventional accounting standards

3.5.1 From a Western perspective

Conventional accounting with its functionalist approach has been criticised by many authors and researchers. For instance, Alexander *et al* (2005) states that with regard to the importance of economic and cultural elements, there are elements causing differences in accounting information such as differences in accounting systems which include: a) organisation of accounting regulations; and b) the organisation of the accounting profession. They also state that national differences affect uniformity of the accounting information contained in the financial statements. They state that "even when all companies comply with US GAAP or IAS/IFRS, national influence still plays a role in a future"(Page37). Hameed (2000b) argues that the decision-usefulness framework for accounting seems to dominate the accounting mainstream. Accounting information should be instrumental in the economic decision. Among the concerns expressed are that decision usefulness undermines the stewardship function, as it gives priority to the shareholders, investors, and creditors instead of the society as a whole.

However, Blake and Amat (1998) state that the formation of accounting standards brings benefits to international business, particularly within the European Union (EU). Obstacles to the work of the bodies promoting this formation include:

1. Differences in the regulatory framework in each country limit which the influence of the accounting profession in supporting IASC.

2. The 'true and fair view', the fundamental principle on which EU formation is built, varies in its interpretation.

3. A binding tax-accounting link ties accounting practices to national tax rules rather than international norm.

Schweikart (1985) proposes that environmental factors (e.g., economic, educational, political) condition the institutional structure (e.g., corporations, stock exchanges) and the decision-makers (e.g., investors and lenders) across nations. These structures, subject to cultural idiosyncrasies, contribute to the type and amount of information provided to the public in a particular country.

Gray *et al* (1993) identify four primary values that distinguish national accounting systems; professionalism (versus statutory control), namely the extent to which a nation's accounting system allows for a broad range of personal judgments versus rigid, legalistic control; uniformity (versus flexibility), namely the degree to which a system allows for differential handling of the idiosyncrasies prevalent in accounting events; conservatism (versus optimism), namely the extent to which a system prefers a cautious approach to measurement to cope with the uncertainty of future events versus a more optimistic, risk-taking approach; and secrecy (versus transparency), namely the degree to which a system allows for restriction of information to those closely involved with the entity's management and financing versus a more transparent, publicly accountable approach.

Harrison and McKinnon (1999) conclude that accounting system change relies principally on intrusive events, intersystem activity, trans-system activity, and cultural environment. Robson (1993) posits that accounting systems change to provide a vehicle to translate economic needs to other extant systems within the environment.

From this theoretical base, Doupnik and Salter (1995) settle on three principal categories that determine a nation's accounting development: the external environment, cultural values and the institutional structure. Using this framework, they test environmental measures for the legal system, the nature of the relationship between business enterprises and providers of capital, the tax laws, the inflation levels, the level of education, and the level of economic development. Relying on Gray's (1988) work, they also include Hofstede's (1980) four cultural variables: individualism/collectivism, uncertainty avoidance, power distance, and masculinity.

Doupnik and Salter (1995) perform canonical analysis and other tests that relate the underlying dimensions of accounting practice to their 10 predictor variables. Their results show that the legal system variable is very important, with code-based countries leaning heavily toward macro-based system indicators. Uncertainty avoidance and reliance on equity capital are the two other very significant variables. Uncertainty avoidance is positively related to macro-based system indicators and reliance on equity capital is negatively related to macro-based systems. These three variables dominate the other predictor variables in the analysis. Doupnik and Salter (1995) also suggest that the legal system is an institutional indicator that influences not only how accounting rules are promulgated, but also the content of the rules. For example, code-based systems generally are more rigid and allow for less discretion in application than common-law systems. Radebaugh and Gray (1997) identify France and Germany as examples of countries with traditions of code-based law and the United Kingdom and the United States as representatives of countries with a common-law heritage.

Doupnik and Salter (1995) also report that countries that rely on equity-based financing will generate more sophisticated accounting information, because stakeholders in these countries have limited access to alternative sources of information. That is, in countries where bankers, governments, or families are the primary sources of financing, access to private information reduces the need and desire to develop more open and informative accounting systems. Radebaugh and Gray (1997) further indicate that share ownership is much more widespread in the United States than in France and Germany. They also indicate that the government is a major source of financing in France, while in Germany banks are the major source. Radebaugh and Gray (1997) also cite evidence from the International Finance Corporation 1993 showing that in 1992 the United States had just under one-half of all market capitalization in the world and over 13 times as much as France and Germany.

In addition, Sharp and Salter (1997) state that national cultural characteristics may interact with behavioural propositions. This result is supported by a study conducted by Schultz and Lopez (2001) with the interpretation that experienced accountants from countries high on uncertainty avoidance are more sensitive to framing effects than accountants from low-uncertainty avoidance countries. These results suggest that the phrasing of international accounting standards or the way that accountants interpret those standards may play an unintended role in accounting measurement across nations.

However, Alexander *et al* (2005) outline the major influencing factors which led to differences in the development of national accounting environments and national reporting practices from the 18^{th} century until almost the end of the 20^{th} century. Empirical research conducted in the 1970s and 1980s indicated the following variables as important determinants of those differences: provision of influence, the legal system, the link between accounting and taxation and cultural values.

Cultural values, it has been thus noted, play a special role in defining the differences in the development of accounting systems and particularly individual judgments related to accounting measurements and disclosures. Gray (1988) expands on this maxim suggesting that cultural values arise over long periods and contribute to the formation of institutions and other environmental elements. This is further supported by the definition of culture offered by Hofstede (1980) He defines culture as "a collective programming of the mind which distinguishes one group from another" (p. 25). Each country, therefore, has specific characteristics. These characteristic formulate the accounting information need and the accounting system as well. Some of these characteristics are related to the environment, others to the culture and economy and others to religions.

3.5.2 Contradictions to Islamic teachings

Many studies have indicated that conventional accounting has resulted in a situation which contradicts the Islamic socio-economic economic objectives. For example, Gray (1994) asserts that conventional accounting has directed organisational growth at the cost of environmental degradation. He argues that this could have happened because conventional accounting as the scorekeeper in evaluating the performance of an organization, does not take the environment into account. Briloff (1996) argues that conventional accounting has led to the concentration of wealth by a few individuals at the expense of society. Further, Arnold and Cooper (1999) find that it has led to the loss of jobs through downsizing and transfer of wealth through privatization.

However, Hameed (2000a) states that these contradictions are caused by the use of decision usefulness objectives in conventional accounting. He admits that although the term 'decision usefulness' seems rational, harmless and acceptable from an Islamic perspective when this concept is examined in depth, a number of problems arise. Firstly, conventional accounting focuses on informational efficiency in the capital market from the perspective of the shareholders and the resulting equilibrium may not therefore be efficient from the perspective of other members of society such as employees, government and the community at large. Secondly, conventional accounting operates in an assumed pristine liberal economic society (Gray *et al*, 1996). In this type of society, the increasing gap between the rich and the poor is not questioned and there is no room for environmental and ethical values other than utilitarian self interest. Thirdly, the decision usefulness paradigm on which conventional accounting is based was born in the countries with developed capital markets. Meanwhile, many Muslim countries have not established or developed stock exchanges and the economy is non-monetized. Therefore, in such a situation, the decision usefulness of accounting orientated toward the market does not make any social or economic sense.

Hameed (2000b) shows that the characteristics of conventional accounting are utilized for the enrichment of shareholders and creditors even at the expense of damaging social and environmental consequences. In particular, Adnan and Gaffikin (1997) state that some accounting concepts are contradictory to Islamic principles. They cite, for instance, that the concept of historical cost and conservatism can be misleading and cannot guarantee the quality of justice and honesty within the information it carries. They argue that such concepts have no room in accounting within Islamic institutions. Meanwhile, the conservatism concept could also oppose the *Qur'an* and *Sunnah* as it would distort accounting data. They argue that conservatively reported data are not only subject to improper interpretation, but also contradict the objective to disclose all relevant information related to the particular company.

Abdelgader (1994) considers the stability of the purchasing power of the monetary unit concept revealing that this concept inherently contradicts Islamic principles, as in an inflationary environment, the money as a unit of measure is unable to serve as a just and honest unit of account. It makes money an inequitable standard of deferred payments and an untrustworthy store of value and would encourage some people to be unfair to others even though unknowingly. Abdelgader (1994) also states that the realization concept particularly for the Islamic bank would create a problem, as it dose not achieve fairness for withdrawing depositors. This concept suggests that the earning process for the revenues of the bank should be known and should be collectible to a reasonable degree, if not already collected. This means that if some depositors withdraw before the full liquidation of the project in which their funds have actually participated, they may lose a part of the profit that might be realized in the future. Therefore, it can be concluded that conventional accounting often results in organizational practices that are contradictory to Islamic principles.

3.5.3 Irrelevance to Islamic accounting objectives

Adnan and Gaffikin (1997) believe that some of the accounting concepts in conventional accounting are irrelevant to Islamic accounting. The matching concept for instance, is considered irrelevant because it leads to the preference for the revenue-expense approach rather than the asset liability approach. In fact, if the objective of accounting in Islam is to uphold the accountability through *Zakat* as Adnan and Gaffikin (1997) propose, the asset-liability approach needs to be applied. Besides the matching concept, the objectivity concept is also considered as irrelevant. Adnan and Gaffikin (1997) argue that putting objectivity in the context of qualitative characteristics indicates that it is related more to the secondary objectives of accounting information, which is to facilitate accounting users in making legitimate economic decisions for their own interests. Therefore, since the primary objective of Islamic accounting is for *Zakat* accountability, the objectivity concept is basically not relevant to the main concern of a primary objective in *Zakat*.

3.5.4 Insufficiency in achieving Islamic socioeconomic objectives

Hameed (2000a) asserts that the main accounting reports of conventional accounting (e.g. the income statement, balance sheet, cash flow statement and other subsequent or extraordinary events information) are considered important in Islamic accounting and could continue to be applied. This is because investors and other financial providers are also members of society and they must reveal their due rights. In this case, the calculation of profits is absolutely essential in order for various parties to obtain their just and fair share. However, that information is insufficient for Islamic society which should uphold accountability to Allah (as the primary accountee) and to men (as the secondary accountee). Therefore, the uniqueness of Islamic accounting would be to provide other types of information in an integrated manner in the accounting report or statement.

3.5.5 Lack in conformity with Islamic norm

Studies conducted by AAOIFI (2002) reveal that the lack of approved standards to be followed by Islamic banks in particular has a negative effect on the confidence of the users of their financial statements and the information contained therein. This is reflected in a negative attitude towards dealing with Islamic banks and hesitation in investing, depositing, and exchanging services with them. Among the reasons given are (Karim, 1990):

- Accounting standards established in various parts of the world were developed and issued to cope with the environment of the issuing country. Among the factors which influence the achievement of Islamic banks are the *Sharia'h* requirements related to the activities of banks.

- There are major differences between Islamic banks and traditional banks with which Islamic banks are compared, the most important of which are *Sharia'h* requirements and the different economic substance of many of its important operations.

- The information needed by users of financial statements of Islamic banks is different from that which is needed by users of counterpart of traditional banks.

- The statements being used by the Islamic banks and financial institutions themselves are different from one country to another, from one bank to another in the same country and sometimes from one year to another from the same bank.

In addition, Haqiqi and Pomeranz (1987) state that there is:

1. Absence of accounting (and auditing) standards pertaining to Islamic society: uncertainty in accounting principles is inherent in revenue realisation, disclosure

of accounting information, accounting bases, valuation, revenue and expense matching, etc.

2. Lack of uniform standards of credit analysis: for instance, Islamic banks have no appropriate standards of credit analysis, especially for Profit and Loss Sharing (PLS) schemes.

3. Absence of independent and appropriately advised standards-setting bodies which could serve the needs of Islamic financial institutions in general and Islamic banks in particular. They would be responsible for establishing and regulating accounting standards based on and rising from the root of Islamic *Sharia'h.*

4. Lack of knowledge as well as the absence of board agreement to what constitutes Islamic accounting, and the pervasive influence of traditional accounting concepts in Islamic society.

It can be seen that there is a need for a specific accounting body which is based on *Sharia'h* law. The aim of this body would be to provide Islamic banks and other Islamic financial organisations with appropriate accounting standards to enable them to fulfil their objective toward their customers and the society in which they operate.

3.6 Summary

This chapter discussed Islamic banks and the relationship between accounting standards and their applications in these banks. This chapter highlighted the objectives and specific characteristics of Islamic financial reports, the need for accounting standards to fit with Islamic society's objectives and to fulfil the users' needs of such information.

High-quality financial information is essential to analyse and assess the investment opportunities to ensure efficient allocation of capital. The absence of accounting standards would prevent comparability of financial information between published statements issued by business enterprises. In addition, explicit and lengthy statements would be necessary to the accounting information receivers to interpret and use it properly. These broad principles of financial reporting form the basis of the AAOIFI report "Framework for the Preparation and Presentation of Financial Statements". AAOIFI adds a new objective of financial reporting; namely, to provide information to assist the concerned party in the determination of *Zakat* on the Islamic bank's funds and the purpose for which it will be disbursed.

Traditional accounting postulates and principles are largely accepted and more usable in the environment where they are published. However, some of these postulates and principles do not comply with fairness accounting; they are subject to considerable debate and criticism, even from a conventional point of view. In addition, some of these postulates and principles are inconsistent with Islamic *Sharia'h* law. Furthermore, these postulates require the continuous examination of the current practice and as such would be a stimulus to change, reflecting the 'economic truth'.

Additionally, in accordance with the requirement for Islamic financial institutions to be fair and just *Zakat* should be paid annually. Benston (1980) states that the methods of establishing and enforcing accounting standards are: evolution and voluntary individual compliance, private accounting bodies and governmental structure. Therefore, it is better to look for accounting standards which achieve Islamic financial institutions' objectives, meet the customers' needs and are consistent with requirements and objectives of the society where they are applied. This requires application of *Sharia'h* law in setting Islamic accounting standards.

Therefore, a specific organisation to regulate and supervise these characteristics is inevitable. A substantial community of accounting practitioners and scholars is needed. Islamic banking practitioners may also be required to participate in setting Islamic accounting standards. Conceivably, an appropriately advised standard-setting body could serve the need of Islamic financial organisations, bearing in mind the historic cultural and social tradition of the society. The above reasons paved the way to the Accounting and Auditing Organisation for Islamic Financial Institutions

(AAOIFI). AAOIFI was established in 1990 to set accounting standards based on Islamic *Sharia'h*. The body addresses auditing standards and SSB standards as well as accounting problems. The next chapter casts light on this organisation and its role in setting and regulating Islamic accounting standards.

Chapter Four

Accounting and Auditing Organisation for Islamic Financial Institutions as the Islamic accounting standards setting agency

4 Introduction

Accounting can affect many aspects of a business and determine the content of information received. In other words, accounting principles should serve the society where these organisations operate, and provide principles that rise from the culture of that society. As stated in the previous chapter, conventional accounting standards are inconsistent with Islamic norms. Accordingly, this chapter discusses the emergence of Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) as an independent organisation in issuing and regulating Islamic accounting standards. The accounting, auditing, *Sharia'h* and ethics standards issued by AAOIFI are also discussed. It is important for Islamic banks to seek to apply accounting standards based on *Sharia'h* requirements. The AAOIFI standards may fill the gap in this area.

4.1 Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) is an Islamic international autonomous non-profit making corporate body that prepares accounting, auditing, governance, ethics and *Sharia'h* standards for Islamic financial institutions. AAOIFI was established in accordance with an agreement of association which was signed by Islamic financial institutions on 1st Safar, 1410 H corresponding to 26th February 1990 in Algiers. AAOIFI was registered on 11th Ramadan 1411 corresponding to 27th March 1991 in the State of Bahrain (AAOIFI, 2004).

4.1.1 Evolution of the AAOIFI

Phase 1: The emergence (1987 – 1991)

This period witnessed the establishment of the organisation, which extended from 1987 when extensive efforts were made on both administrative and technical levels beginning with the working paper presented by the Islamic Development Bank (IDB) during the annual meeting of its board of governors in Istanbul in March 1987. Thereafter, a number of committees were formed to examine the appropriate methods of preparing accounting standards for Islamic financial institutions. These committees produced several research studies and reports[1].

Phase 2: Building structure (1991 – 1995)

Since its establishment in 1991 and until 1995, the organisational structure of AAOIFI comprised of the Supervisory Committee which consisted of seventeen members, the Financial Accounting Standard Board which consisted of twenty one members, an Executive Committee appointed from within the members of the Standard Board, and the *Sharia'h* Supervisory Committee of four members.

Phase 3: Formation of statute (1995 – 1998)

In this period the Supervisory Committee decided to form a review committee to examine the statutes of AAOIFI and its organisational structure. The amendments that were later introduced in the statute, which were approved by the Supervisory

[1] ***These studies and reports are compiled in five volumes and were lodged in the library of the Islamic Research and Training Institute of the Islamic Development Bank in Jeddah – Saudi Arabia.***

Committee, included the renaming of the organisation and the changing of its organisational structure. The revised structure consisted of a General Assembly, a Board of Trustees (which replaced the Supervisory Committee), an Accounting and Auditing Standard Board (which replaced the former board that was confined to accounting standards only), an Executive Committee, a *Sharia'h* Committee, and a General Secretariat to be headed by a secretary-general.

The amendment of the statute also included changing the method of financing AAOIFI. In the past, AAOIFI was financed by contribution paid by the founding members (Islamic Development Bank, Dar Al Mal Al Islami Group, Al Rajhi Banking & Investment Corporation, Dallah Al Baraka, and Kuwait Finance House). The revised statute calls for the establishment of a *Waqf* (endowment) and charity fund to be financed from membership fees that are paid only once by institutions joining AAOIFI. The proceeds from this fund, the annual subscription fees, grants, donations, bequests and others are the sources from which AAOIFI funds its activities.

The amendment of the statute also included changing the membership of AAOIFI to consist of:

- Founding members
- Non- founding members
- Observer members

4.1.2 Organisation members' criteria

1. **Founding members**: The founding members are the Islamic financial institutions, which are signatories to the agreement establishing the organization in 1989. These are: The Islamic Development Bank, Dallah Al Baraka, Faysal Group (Dar Al Maal Al Islami), Al Rajhi Banking & Investment Corporation and Kuwait Finance House.

2. **Associate members:**

   - Islamic financial institutions and companies that comply with Islamic *Sharia'h* rules and principles in all their transactions.

   - Islamic *Fiqh* academies and institutions that have corporate entities.

3. **Members representing regulatory and supervisory authorities:** Regulatory and supervisory authorities that supervise Islamic financial institutions.

4. **Observer members:**

   a) Organizations and associations responsible for regulating the accounting and auditing standards and/or those responsible for preparing accounting and auditing standards.

   b) Practicing certified accounting and auditing firms that have interest in the accounting and auditing practices of Islamic financial institutions.

c) Financial institutions engaged in financial activities of Islamic institutions.

d) Users of financial statements of Islamic financial institutions both individual and corporate.

Additional amendments were made to the AAOIFI statute in 1998. These amendments include the broadening of AAOIFI's objectives. Article 4 states the AAOIFI shall:

1. Develop the accounting, auditing and banking practices for use within Islamic financial institutions.

2. Disseminate the principles of accounting and auditing through Islamic financial institutions by training, seminars, publication of periodical newsletters, preparation of research and other means.

3. Prepare, promulgate and interpret accounting and auditing standards for Islamic financial institutions in order to harmonise the accounting practices adopted by these institutions in the preparation of their financial statements, as well as harmonizing the auditing procedures adopted in auditing the financial statements prepared by Islamic financial institutions.

4. Review and amend the accounting and auditing standards for Islamic financial institutions to respond to developments in accounting and auditing thought and practices.

5. Prepare, issue, review and adjust the statements and guidelines on the banking, investment and insurance practices of Islamic financial institutions.

6. Approach the concerned regulatory bodies, Islamic financial institutions and other financial institutions that offer Islamic financial services such as and accounting and auditing firms in order to implement the accounting and auditing standards, as well as the statements and guidelines on the banking, investment and insurance practices of Islamic financial institutions that are published by AAOIFI.

The amendment also includes the renaming of non-founding members as "associate members". Article 3 of the amended statute states that the associate members shall comprise the following:

1. Islamic financial institutions that comply with Islamic *Sharia'h* rules and principles in all their transactions.

2. Regulatory and supervisory authorities that supervise Islamic financial institutions.

3. Regulatory and supervisory authorities including central banks, monetary agencies and other similar authorities.

4. Islamic *Fiqh* academies and authorities that have corporate entity.

The observer members shall comprise the following:

1) Organisations and associations responsible for regulating the accounting and auditing profession and/or those responsible for preparing accounting and auditing standards.

2) Practicing certified accounting and auditing firms that have interest in the accounting and auditing practices of Islamic financial institutions.

3) Financial institutions engaged in the financial activities of Islamic institutions.

4) Users of financial statements of Islamic financial institutions both individual and corporate.

The conditions of membership specified in Article 8 of the amendment statute stipulate that every member should pay the prescribed membership fee and the annual subscription fee. A member should also comply with AAOIFI's statute and by-laws. The amendment of the statute also includes the formation of *Sharia'h* Board instead of *Sharia'h* Committee.

4.1.3 AAOIFI objectives

The broad objectives of AAOIFI can be summarised as follows (Bahrain Monetary Agency, 2002):

1. To develop accounting, auditing, governance and ethical thinking relating to the activities of Islamic financial institutions in accordance with Islamic *Sharia'h* rules.

2. To disseminate the accounting, auditing, governance and ethical thinking relating to the activities of Islamic financial institutions.

3. To harmonize accounting policies and procedures adopted by Islamic financial institutions through the preparation and issuing of standards and their interpretation.

4. To improve the quality and uniformity of auditing and governance practices relating to Islamic financial institutions through the preparation and issuing of auditing and governance standards and their interpretation.

5. To promote good ethical practices in Islamic financial institutions through the preparation and issuing of codes of ethics for the institutions.

6. To achieve conformity in the concepts and applications among the *Sharia'h* supervisory boards of Islamic financial institutions. An important guiding principle is to attempt to avoid contradiction and inconsistency in the *Fatwa* (see glossary) and its application by institutions.

7. To approach regulatory bodies and other concerned institutions in order to enhance the implementation of standards.

4.1.4 Organisational structure

General Assembly

The General Assembly is composed of all funding, associate members and observer members. Observer members have the right to participate in the meeting of the general assembly, but do not have the right to vote. The general assembly is the supreme authority and convenes at least once a year.

Board of Trustees

The Board of Trustees is composed of fifteen part-time members who are appointed by the general assembly for a three-year term and they shall continue in office until members of the succeeding board are appointed. Members of the Board of Trustees represent the following categories:

- Regulatory and supervisory authorities.
- Islamic financial institutions.
- *Sharia'h Fiqh* scholar.
- Professional accounting and auditing in Islamic financial institutions.
- Users of financial statements issued by Islamic financial institutions.

The conditions of electing these members are specified in article 12 of AAOIFI statute. The Board of Trustees meets at least once a year. With the exception of the proposals to amend the statute of AAOIFI that requires the vote of three quarters of the members of the Board of Trustees, the majority of the members vote to adopt decisions in all matters before the Board. In the case of equal division voting, the chairman has the casting vote. The powers of the Board of Trustees include, among others, the following:

- Appointment of members of AAOIFI's boards and termination of their membership, in accordance with the provisions of the statute.
- Arrangement and investment of sources of finance for AAOIFI.
- Appointment of two members from amongst the members of the board of trustees to the executive committee.
- Appointment of the secretary-general.

Notwithstanding, the provisions of the statute concerning the Board of Trustees' power and authorities, neither the Board of Trustees nor any of its subcommittees including the executive committee, has the right to interfere directly or indirectly in the work of the other boards of AAOIFI or influence them in any manner whatsoever.

Accounting and Auditing Standards Board:

The Standards Board is composed of fifteen part-time members who are appointed by the Board of Trustees for a four-year term. Members of the Standards Board represent the following categories:

- Regulatory and supervisory authorities.
- Islamic financial institutions.
- *Sharia'h Fiqh* scholars.

- Accounting and auditing profession that relates to the work of Islamic financial institutions.
- Users of financial statements of Islamic financial institutions.
- University professors in accounting and financial studies.

The powers of the Standards Board include, among others, the following:

- To prepare, adopt, and interpret accounting, auditing and governance statements, standards and guidelines for Islamic financial institutions.
- To prepare and adopt a code of ethics and educational standards relating to the activities of Islamic financial institutions.
- To review with the aim of making additions, deletions or amendments to any accounting, auditing, governance and ethical statements, standards and guidelines for Islamic financial institutions prepared by the Accounting and Auditing Standards Board, to oversee the means by which Islamic financial institutions to meet the needs of the users of the financial statements of these institutions.
- To prepare and adopt the due process for the preparation of standards, as well as the regulations and by-laws of the Accounting and Auditing Standards Board.

The Standards Board meets at least twice every year and the majority of the votes of the members voting adopt its resolutions. In case of a tie, the chairman of the Standards Board shall have the casting vote.

The *Sharia'h* Board

In order to ensure that the practices and activities of Islamic banks do not contradict Islamic ethical standards, Islamic banks are expected to establish a *Sharia'h* Supervisory Board based on Muslim jurisprudence, which acts as an advisory body to the banks. The *Sharia'h* Board is composed of not more than fifteen members to be appointed by the Board of Trustees for a four-year term from among *Fiqh* scholars who represent *Sharia'h* supervisory boards in the Islamic financial institutions that are members of AAOIFI, and the *Sharia'h* supervisory board in the central bank.

The powers of the *Sharia'h* Board include, among others, the following;

1. Achieving harmonisation and convergence in the concepts and application among the *Sharia'h* supervisory board of Islamic financial institutions to avoid contradiction or inconsistency between the *Fatwas* and applications by these institutions, thereby providing a pro-active role for the *Sharia'h* supervisory boards of Islamic financial institutions and the central bank.

2. Helping in the development of *Sharia'h* approved instruments, thereby enabling Islamic financial institutions to cope with the developments taking place in instruments and formulas in the fields of finance, investment and other banking services.

3. Examining any inquiries referred to the *Sharia'h* Board from Islamic financial institutions or from their *Sharia'h* opinion in matters requiring collective *Ejtihad* (reasoning), or to settle divergent points of view, or to act as an arbitrator.

General Secretariat

The General Secretariat consists of the Secretary-General and the technical and administrative units. The Secretary-General is the executive director of AAOIFl. He co-ordinates the activities of the General Assembly, the Board of Trustees, the Standards Board, *Sharia'h* Board, the Executive Committee and the subcommittees. He also co-ordinates and supervises the preparation of statements, standards and guidelines promulgated by AAOIFI. The responsibility of the Secretary-General also includes strengthening ties between AAOIFI and other organisations and representing AAOIFI at conferences and seminars and scientific meetings.

Alchaar (2005) states that since 1991, when the Islamic banking and finance industry itself decided that the existing international standards were inadequate to cater for its needs, the AAOIFI has come a long way to being recognised as the main standard-setting organisation. The rècent singling-out by the World Bank of AAOIFI in a case study as an example of a successful self-regulatory organisation clearly demonstrates the recognition and respect that the organisation has attained. AAOIFI have now issued 50 standards on accounting, auditing, governance, ethical and *Sharia'h* standards. Over the years, AAOIFI has taken significant steps to encourage the application and enforcement of its standards throughout the world. AAOIFI have done so by producing high-quality standards that are internationally recognised. It is only by international recognition and consistent application of these standards that the Islamic banking and finance industry will realise the full benefits of accurate and transparent financial reporting, and accomplish the vision of a global Islamic financial architecture.

As the main avenue for the interface between market players and regulators, the organisation has made a particular effort to ensure that interested parties are in fundamental agreement over its standards setting process. As such, this has resulted in standards being implemented in the leading Islamic banking and finance centres globally, such as Bahrain, Sudan, Jordan, Malaysia, Qatar and Saudi Arabia where they are either mandatory or used as a guideline by the regulators. Moreover, the AAOIFI's membership represents 24 countries, consisting of 105 members.

The continued success of an organisation depends on its ability to build a team of dedicated and experienced individuals, and to lay down a strong foundation and structure. This will be the main mission of the organisation in the coming period as it continues to develop new standards and encourages application of these standards. Apart from the conferences and seminars planned, the AAOIFI will also be involved in various consulting projects in the areas of financial reporting, banking and financial markets, to ensure that the expertise gained over the years is shared with the industry globally. The Certified Islamic Public Accountant (CIPA) programme planned will also provide the industry with qualified personnel, and further strengthen its knowledge base. The staff of the organisation will continue to work and cooperate with other standard setters and international agencies for the betterment of the industry.

4.2 Differences between AAOIFI standards and IASs and ontological implementations

A study conducted by AAOIFI to compare the body of IASs with that of Financial Accounting Standards (FAS) states the following differences (Archer, 2001):

1. There are IASs for which there is no comparable FAS, because the type of financial statement item covered by the IAS do not raise any issue of *Sharia'h* compliance and AAOIFI has not needed to issue a separate standard. An example is IAS 16 Property, plant and equipment (IASC 1998a), as Islamic financial institutions have no problem in applying IAS 16.

2. There are IASs for which there is no comparable FAS, because the types of financial statement item covered by the IAS do not appear in the financial statements of the Islamic financial institutions as they can result only from non-*Sharia'h* complaints (*haram*) transactions. An example is IAS 23 Borrowing Costs (IAS 1993b).

3. There are FASs which are compatible with, but not identical to IASs that cover the relevant types of financial statement item. An example is FAS 10 *Istisna'a* and *Parallel Istisna'a* (AAOIFI 1998) which is compatible with IAS 11 Construction Contracts (IAS 1993a), but deals with matter not covered by IAS 11. (*Istisna'a* is a *Sharia'h* compliant credit facility whereby the Islamic bank, or other provider of funds, provides financing for a manufacturing or construction contract by acting as the purchaser of the assets to be produced and making payment in advance).

4. There are FASs for which there is no comparable IAS, because the FAS deal with a type of financial statement item that is found only in the financial statements of Islamic financial institutions. An example (referred to above) is FAS 6 Equity of (Profit Sharing) Investment Accounts and their Equivalents (AAOIFI 1997).

5. There are FASs which deal with items that are similar to items dealt with by an IAS, but the two standards are not compatible. An example is FAS 2 *Mudaraba* and *Mudaraba* to the Purchase Order (AAOIFI 1995), which covers Islamic credit-sale transactions, but is not compatible with the requirements of IAS 18 (IASC 1993b) for (conventional) Credit Sale Transactions.

These differences demonstrate that the Islamic banks should apply FAS, which are issued by Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) to obtain their objectives and satisfy their customer by avoiding prohibited transactions.

4.3 Mechanism of dealing with AAOIFI's Standards

Karim (1995) argues that there are two ways in which Islamic accounting concepts could be arrived at:

1. Establish objectives (and concepts) based on the principles of Islam and its teachings and consider these objectives in relation to contemporary accounting thought.

2. Start with the objectives established in contemporary accounting thought, test them against the Islamic *Sharia'h*, accept those that are consistent with *Sharia'h* and reject those that are not, and develop those that are unique.

The AAOIFI (1996) has adopted the second, easier approach in the development of their "Statements of Financial Accounting" which they claim is "consistent with the broader view of Islamic principles - a view which does not require that a concept be always be derived from the *Sharia'h*", (p24 and p37). This approach is in line with the Islamic judicial principle of *Ibaha* or permissibility (which itself is not uncontested); it suggests that anything is permissible unless it is prohibited clearly by the *Sharia'h*. Hence, the concepts of decision useful accounting information such as relevance and reliability are immediately embraced into Islamic accounting by the AAOIFI. This approach has its supporters [e.g. Ahmad & Hamat 1992] (Abdelgader, 1994).

However, this approach has been objected to earlier by Gambling & Karim (1991) on the grounds that the conceptual framework of accounting currently applied in the West is justified in a dichotomy between business morality and private morality. Thus it cannot be implemented in other societies that have revealed doctrines and morals that govern all social, economic and political aspects of life. Further objections to this method arise because neither Western accounting theory nor Western accounting standards explicitly deal with the morality of the objectives of commercial accounting entities or even of the methods by which they are pursued (Hameed, *et al.*, 1993 as quoted by Karim, 1995). Hence, the approach of not reinventing the wheel adopted by the AAOIFI may be indefensible. The AAOIFI has adopted this approach not because of its correctness or intellectual apathy, but due to pragmatic considerations of its survival and acceptance of its standards by Islamic Banks. Thus:

"In order to gain the recognition and support of Islamic banks in the implementation of its standards, the [AAOIFI] might find it necessary to demonstrate to Islamic Banks that it has not completely discarded the efforts that they have exerted in setting up their own accounting policies with the help of their SSB". (Karim, 1995, p292)

According to the AAOIFI (2004) the mechanism of this organization is as follows:

a) The starting basis is that all Islamic financial institutions should apply – whether by regulatory or *Sharia'h* requirement – the standards issued by the Accounting and Auditing Organization for Islamic Financial Institutions, where such standards are available.

b) When there are no specific standards, the Islamic financial institution may use standards other than those issued by AAOIFI as deemed appropriate, which do not contravene the *Sharia'h* Rules and Principles.

c) Should the requirements of such standards mentioned in paragraph (b) be in conflict with *Sharia'h* Rules and Principles, and the institution is compelled to use those standards, a disclosure must be made of the point of conflict while adhering to the requirements of a *Sharia'h* necessity.

d) Whenever AAOIFI issue standards that cover the cases in paragraphs (b) and (c), the Islamic financial institution must apply the new standards.

4.4 AAOIFI standards

Islamic banks have been established to assist Muslims and Islamic societies in using money in a beneficial manner consistent with the principles of Islamic *Sharia'h*. These banks have now become an important means of attracting deposits whose owners wish to invest in ways and means consistent with the rules and principles of *Sharia'h.* Such ways and means are characterized by many features, including the prohibition of interest, profit and loss sharing and other investment vehicles, and the avoidance of activities that *Allah* has forbidden. Accordingly, the attractiveness of Islamic banks to the Muslim stems mainly from their compliance with *Sharia'h* in their dealings, whether with shareholders, depositors, or others with whom such banks invest their funds.

On the other hand, financial accounting plays an important role in providing the information which users of the financial statements of Islamic banks depend on in assessing the bank's compliance with the precepts of *Sharia'h.* However, to perform this role effectively, accounting standards need to be developed and complied with by Islamic banks. The development of such standards must be based on clear objectives of financial accounting and agreed upon definitions of its concepts (AAOIFI, 2002). AAOIFI, since its establishment in 1990 until 2005 AAOIFI have issued 50 standards on accounting, auditing, governance, ethical and *Sharia'h* standards (Alchaar 2005).

In this section, the discussion is restricted to the accounting, auditing and governance standards pertaining to the Islamic banks that have been issued by the end of 2002. The AAOIFI has published standards No, 12, 13, and 15, for insurance companies, and standards No, 14, and 17 for investment funds, and standard No, 18 for Islamic financial services offered by conventional financial institutions.

4.4.1 Accounting standards

Before delving into the accounting standards, it is worth noting that the AAOIFI issued two statements of financial accounting; the following is a description of these statements:

- **Statement of financial accounting No 1**

This statement defines the objectives of financial accounting of Islamic banks and financial institutions, the financial accounting processes, and the importance of establishing objectives of financial accounting for Islamic banks and other financial institutions. The statement of financial accounting was adopted by the board in its meeting No. 5 held in October 1993.

- **Statement of financial accounting No 2**

This statement of the concepts of financial accounting of Islamic banks has been prepared to express basic principles of financial accounting. The approach used in developing this statement consists of the identification of accounting concepts which have been developed by other institutions that are consistent with the Islamic ideals of accuracy and fairness, the identification of concepts which are used in traditional financial accounting, but are inconsistent with Islamic *Sharia'h*, and the development of those concepts defining certain aspects of financial accounting for Islamic banks that are unique to the Islamic method of business transaction. The adoption of this statement was determined in the Board meeting No. 5 held in October 1993.

Standard No 1: General presentation and disclosure in the financial statements of Islamic banks and financial institutions

This standard presents the general presentation and disclosure of financial statements of Islamic banks and financial institutions. In other words, this standard is applicable to the financial statements published by Islamic banks to meet the common information needs of the main users of such statements. Furthermore, this standard is applicable to all Islamic banks regardless of their legal form, countries, or size. The standard presents the complete set of financial statements, the comparative financial statements, general disclosure in the financial statements, presentation and disclosure in each statement, and finally presents treatment of changes in accounting policy. The adoption date of this standard was in October 1993, and was effective for financial statements for the fiscal period beginning 1 January 1996.

Standard No 2: *Murabaha* and *Murabaha to the purchase orderer*

This standard governs sales in which two parties or more negotiate and promise each other to execute an agreement according to which the orderer asks the purchaser to purchase an asset of which the latter will take legal possession. The orderer promises the purchaser to purchase the asset from him and give the ordered a profit thereon. The two parties would conclude a sale after the possession of the ordered to the asset. However, the purchase orderer may or may not be obliged to conclude the sale. The standard shall apply whether the Islamic bank buys assets exclusively from its own funds, from the pool of co-mingled funds comprising the Islamic bank's own funds and unrestricted investment accounts, or from restricted investment account funds. The standards deal with juristic rules for the transactions of *Murabaha* and *Murabaha* to the purchase orderer, types of *Murabaha* to the purchase orderer, and general *Murabaha* rules. This standard was adopted by the Board in its meeting No, 10 held on 5 February 1996, and shall be effective for financial statements for the fiscal period beginning 1 January 1998.

Standard No 3: *Mudaraba* financing

AAOIFI (2002) defines *Mudaraba*, as a partnership in profit between capital and work. It may be conducted between investment account holders as providers of funds and the Islamic bank as a *Mudarib*. The Islamic bank announces its willingness to accept the funds of investment amount holders, the sharing of profits being as agreed between the two parties, and the losses being borne by the providers of funds except if they were subject to misconduct, negligence or violation of the condition agreed upon by the Islamic bank. In the latter cases, such losses would be borne by the Islamic bank. A *Mudaraba* contract may also be conducted between the Islamic bank, as a provider of funds, on behalf of itself or on behalf of investment account holders, and business owners and other craftsmen, including farmers, traders etc. *Mudaraba* differs from what is known as speculation which includes an element of gambling in buying and selling transaction. This standard provides details about the accounting treatment of *Mudaraba* financing, terms and elements of *Mudaraba*, and *Mudaraba* rules. It also provides details of the juristic principles on which the development of the proposed accounting treatment is based. It also highlights the different accounting alternatives which have been considered and the justifications for the alternative chosen for the accounting treatments of *Mudaraba* financing. The adoption of this standard was in the Board meeting held in 5th February 1996, and shall be effective for financial statements for the fiscal period beginning 1 January 1998.

Standard No 4: *Musharaka* financing

This standard aims at setting out accounting rules for recognising, measuring, and disclosing the transactions of *Musharaka* financing that are carried out by Islamic banks and other financial institutions. *Musharaka* commingles funds for the purpose of sharing in profit. However, this standard does not include *Mudaraba*, participations, *Zakat* on *Musharaka* funds, and the accounting treatment of *Musharaka* transactions in the partner's books and the *Musharaka* records. The main points discussed were the accounting treatment of *Musharaka* financing, categories of *Musharaka*, *Musharaka* elements, and *Musharaka* rules. The adoption of this standard was in the meeting held on 5th of February 1996, and shall be effective for financial statements for the fiscal period beginning 1 January 1998.

Standard No 5: Disclosure of bases for profit allocation between owners' equity and investment account holders.

This standard is applicable to the financial statements published by Islamic banks to meet the common information needs of the main users of such statements. For example, disclosure on unrestricted investment accounts to disclose significant accounting policies applied by the Islamic bank, restricted investment accounts to disclose (in the note) the significant accounting policies, the percentage of profit allocation between owners' equity and restricted investment account holders, incentive profits to disclose the basis for determining the incentive profits which it receives from the profits of both unrestricted and restricted investment account holders and finally general disclosure requirements as stated in financial accounting statement No1. This standard is applicable to all Islamic banks regardless of their legal form, location or size. The effective date of this standard for financial statements began on 1 January 1998.

Standards No 6: Equity of investment account holders and their equivalent

This standard addresses the accounting rules relating to funds received by the Islamic bank for investment in its capacity as a *Mudarib.* Investments are made in whatever manner the Islamic bank deems appropriate dealing with equity from both unrestricted investment account holders. This standard does not address funds received by the Islamic bank on a basis other than the *Mudaraba* contract. It is also does not address how to calculate *Zakat* on the equity of investment account holders (para 2). On the other hand, the standard presents a definition of

Mudaraba for both unrestricted investment accounts and restricted investment accounts. Moreover, it addresses the accounting question of how to treat the equity of investment account holders and it also outlines presentation and disclosure requirements. This standard is effective for financial statements for the financial period beginning on 1 January 1999.

Standard No 7: ***Salam and parallel Salam.***

Some scholars define the *Salam* as "Purchase of a commodity for deferred delivery in exchange for immediate payment according to specified conditions or sale of a commodity for deferred delivery in exchange for immediate payment" (BMA 2002). This standard addresses the accounting rules of *Salam* financing and *Parallel Salam* transactions. This standard treats all aspects of this kind of transaction such as: accounting treatments of *Salam* financing and *parallel Salam* transactions; defining transaction parts; juristic rules of *Salam* and *parallel Salam*; and disclosure requirements in such cases. The adoption date of the standard was agreed at the meeting held in 1997, and the effective date for the standard is for financial statements for fiscal periods beginning 1 January 1999.

Standard No 8: ***Ijara and Ijara Muntahia Bittamleek***

Some scholars have defined *Ijara* as "Ownership of the right to the benefit of using an asset in return for consideration". Others have added the duration of the benefit to the definition (AAOIFI, 2002). This standard regulates all transactions which fall under this meaning that are carried out by Islamic banks and financial institutions. However, the standard does not address *Ijara* agreement for exploration or use of natural resources, such as oil or gas. *Ijara* transactions concerning the licensing agreements of certain items such as motion pictures, video recordings, manuscripts, copy writing and also labour contracts and hiring of professional services. On the other hand, this standard presents definitions of *Ijara*, operating *Ijara, Ijara Muntahia Bittamleek,* fair value of leased assets and residual value. It also details the accounting treatment of *Ijara* and *Ijara Muntahia Bittamleek.* This standard was adopted in the Board meeting held on 16 June 1997, and is effective for financial statements for the fiscal period beginning 1 January 1999.

Standard No 9: *Zakat*

Zakat is a specified amount prescribed by *Allah* the almighty for those who are entitled to *Zakat* as specified in the *Qur'an.* The word *Zakat* is also used to indicate the amount paid from the funds that are subject to *Zakat* (AAOIFI, 2002). This standard aims at setting out accounting rules for the treatments related to the determination of the *Zakat* base, measurement of items included in the *Zakat* base, disclosure of *Zakat* in the financial statements of the Islamic banks and other financial institutions. The standard is discussed in detail later on. This standard was adopted by the Board in its meeting held on 22 June 1998, and is effective for financial statements for the fiscal period beginning 1 January 1999.

Standard No 10: ***Istisna'a and Parallel Istisna'a***

Istisna'a is a sale contract between *Al-mustasne'e* (the ultimate purchaser) and *Al-sane'e* (seller), whereby *Al-sane'e* is based on an order from the *Al-mustasne'e* who undertakes to have manufactured or otherwise acquire *Al-masno'e* (subject matter of the contract) according to specification and sell it to *Al-mustasne'e* for an agreed upon price and method of settlement whatever that be at the time of contracting, either by instalments or deferent to a specific future time. It is a condition of the *Istisna'a* contract that *Al-sane'e* should provide either the raw material or the labour. Accordingly, this standard addresses measuring and recognising the costs and revenues from *Istisna'a and parallel Istisna'a*, the gains and losses accruing therein, and their presentation and disclosure in the financial statements of the Islamic bank. This standard presents the accounting treatment by the Islamic bank for *Al-sane'e* (seller), the accounting treatment of *Istisna'a* by the Islamic bank for *Al-mustani'e* (buyer), and the disclosure requirement in such cases. This standard was adopted by the Board on 22 June 1998, and is effective for financial statements for the fiscal period beginning 1 January 1999.

Standard No 11: Provisions and reserves

This standard aims to set out the accounting treatment used to revalue the Islamic bank's receivables, financing and investment assets. Further, it sets out the accounting rules for the reserves which the *Mudarib* share ensuring a return, perhaps from profit, for the investment account holders after allocating the *mudarib* share. This caters against future losses for investment account holders.

The standard also defines provisions, recognition of provisions, and measurement of provisions, presentation requirements, and disclosure requirements. The standard also defines the reserves, types of reserves and the sources from which they should be deducted. It outlines presentation and disclosure requirements and also standards on recognition and measurement of reserves. The standard was adopted by the Accounting and Auditing Standards Board in its meeting held on 13-14 June 1999, and is effective from the period beginning 1 January 2001.

Standard No 16: Foreign currency transactions and foreign operations (not examined in this study)

This standard sets out the accounting rules for recognising, measuring, presenting and disclosing transactions in various currencies other than the reporting currency of the Islamic bank, whether such transactions relate to assets, liabilities, off-balance sheet items, revenues, expenses or gains or losses in the financial statements. Therefore, the standard addresses the accounting treatment for foreign currency transactions, the accounting treatment for the purpose of preparing financial statements, presentation requirements and disclosure in the notes to the financial statements. Further, the standard presents definitions of exchange rate, foreign currency, exchange differences, forward exchange rate, monetary assets, monetary liabilities, net investment in foreign operations, prevailing rate, and transaction difference measurement. This standard was adopted by the Board in its meeting held on 2 May 2001, and is effective for the financial statements beginning 1 January 2002.

4.4.2 Auditing standards

The purpose of these auditing standards for Islamic financial institutions is to establish standards and provide guidance on the objective and general principles governing an audit of financial statements prepared by a financial institution which conducts business in conformity with Islamic *Sharia'h* rules and principles.

Standard No 1: Objectives and principles of auditing

This standard defines the requirements that should exist in the auditors' procedure and confines the general principles of an audit. In more detail, this standard presents different aspects of the auditing process such as the objective of an audit, the general principle of an audit, the scope of an audit, reasonable assurance, and responsibility for the financial statements. The adoption of this standard was agreed at the Board meeting held on 19-20 May 1996, and is effective for the financial statements for the fiscal period beginning 1 January 1998.

Standard No 2: The auditor's report

The purpose of this standard is to provide guidance on the form and content of the auditor report issued as a result of an audit performed by an independent auditor. This standard explains what the auditor of an Islamic institution is required to do. For example, the auditor should review and assess the conclusions drawn from the audit evidence obtained as the basis for the expression of an opinion on the financial statements. The auditor report should also contain a clear written expression of his opinion on the financial statements taken as a whole. In addition, the standard presents the basic elements that should be included in the auditor report. The report should also perform whether the financial statements comply with statutory requirements. This standard was adopted by the committee in its meeting held in 19-20 May 1996, and is effective for the financial statements for the fiscal period beginning 1 January 1998.

Standard No 3: Terms of audit engagement

This standard aims to provide guidance on the appointment of an auditor to audit financial statements which conduct business in conformity with Islamic *Sharia'h* rules and principles. According to this standard, the auditor and client should agree on the terms of the engagement, the objective of the audit of the financial statements, the scope of the audit, form of reports, fees, and agreement of the terms of engagement etc. The standard was adopted by the Board in its meeting held on 15-16 June 1997, and is effective for the financial statements for the fiscal period beginning 1 January 1998.

Standard No 4: Testing for compliance with *Sharia'h* rules and principles by an external auditor

This standard provides guidance on the subject of testing for compliance with *Sharia'h* rules and principles by an external auditor. The standard address the responsibility of an external auditor for compliance with *Sharia'h* rules and principles, referring to the scope of the auditor's work, reference to the SSB report in the auditor report, and making the auditor's draft report available to the SSB.

This standard was adopted by the Board in its meeting held on 21 May 2000, and shall be effective for the financial statements for the fiscal period beginning 1 January 2002.

4.4.3 Governance standards

One of the main different between Islamic banking and its conventional counterpart is the existence of *Sharia'h* Supervisory Board (SSB) in the structure of Islamic banks. This board guides Islamic banks away from dealing in unlawful transaction which are inconsistent with *Sharia'h* law and Islamic principles. Accordingly, AAOIFI has issued 4 governance standards which regulate and define the role of this Board (Accounting, Auditing and Governance Standards, 2002). The main purpose of these governance standards for Islamic financial institutions in general and Islamic banks in particular is to establish standards and provide guidance on the definition, appointment, composition, and report of the *Sharia'h* Supervisory Board for ensuring compliance of the Islamic financial institutions in all their dealings and transactions with Islamic *Sharia'h* rules and principles.

Standard No 1: *Sharia'h* Supervisory Board: Appointment, composition, and report

Islamic banks are expected to establish a *Sharia'h* Supervisory Board found on Muslim jurisprudence which acts as advisers to the banks. The aim of this standard is to provide guidance on the definition, appointment, composition, and report of the (SSB) for ensuring compliance of Islamic financial institutions in all their transactions with Islamic *Sharia'h* law. The standard addresses the definition of SSB, the appointment of the SSB, the fixing of its remuneration, composition, collection and dismissal. Basic elements to be contained within the SSB report are also fixed. The standard was adopted on 16 June 1997 and is effective for the financial statements for the fiscal period beginning 1 January 1999.

Standard No 2: *Sharia'h* review

The aim of this standard is to provide guidance to assist SSB in performing *Sharia'h* reviews to ensure compliance with Islamic principles. This standard presents the definition and principles of *Sharia'h* review, the objective of the review, the responsibility for compliance with the *Sharia'h* rules, *Sharia'h* review procedure, and the quality assurance, report, and responsibility for implementation of the standard. This standard was adopted in the Board meeting held on 21-22 June 1998 and is effective for the financial statements for the fiscal period beginning 1 January 1998.

Standard No 3: Internal *Sharia'h* review

This standard was established to provide guidance on the requirements of the internal *Sharia'h* review. The standard covers many aspects of the internal *Sharia'h* review such as the objectives and definition of the internal *Sharia'h* review, the scope of its work, its performance, management, quality assurance, and elements of an effective internal *Sharia'h* review control system. The standard was adopted by the Accounting and Auditing Standards Board in its meeting No, 17 held on 13-14 June 1999 and is effective for the financial statements for the fiscal period beginning 1 January 1998.

Standard No 4: Audit and governance committee for Islamic financial institutions

This standard aims to define the role and responsibilities of an Audit and Governance Committee (AGC) for an Islamic financial institution. The standard also highlights the requirements for establishing committees for an Islamic financial organisation and specifies the pre-requisite for an effective AGC. This standard addresses the importance of the AGC, the function of the AGC, its responsibilities and method of establishment. This standard was adopted in the meeting held on 2 May 2001 and is effective for the financial statements for the fiscal period beginning 1 January 1998.

In addition, the AAOIFI has issued a code of ethics for accountants and auditors of Islamic financial institutions. The structure of the code comprises: a) *Sharia'h* foundations of accountants' ethics; b) principles of ethics for accountants; and, c) roles of ethical conduct for the accountant. This code was adopted by the Board in its meeting held on 21-22 June 1998 and is effective for the financial statements for the fiscal period beginning 1 January 1999. Moreover, the organisation has issued a code of ethics for the employees of Islamic financial institutions which regulate the relationship between the employees and employers in accordance with *Sharia'h* guidance. This code was adopted in the board meeting held on 30 April 2002 and is effective for the financial statements for the fiscal period beginning 1 January 2003.

4.5 Examples of the AAOIFI standards implementations

Although the setting of Financial Accounting Standards (FAS) that are applicable internationally to *Sharia'h* compliant financial instruments is compatible with IASs, the FAS involves some additional recognition, measurement or disclosure requirements in order to cater for the specification of the contracts governing the transactions (Archer *et al*, 2002). Here three accounting standards are presented as examples of the implementation of FAS by Islamic banks operating in the State of Bahrain.

4.5.1 *Mudaraba* standard

Mudaraba (trust financing) means that the bank, as a partner, provides cash to the borrower and shares in the net profit or net losses of the business. It may be conducted between investment account holders as a provider of funds and the Islamic bank as a *mudarib*. The loan is for an undetermined period unless the contract is rescinded by either party. *Mudaraba* is considered to be the corner stone of Islamic banking whether in terms of the Islamic bank's relationship with investment account holders or in its relationship with those who request *Mudaraba* financing.

Nevertheless, the field study revealed that Islamic banks do not deal much in *Mudaraba* due to the fact that it is not possible for the bank to interfere in the *mudarib's* work in a way that would enable the Islamic banks to ensure the safe application of funds delivered thereto. To deal with this matter, reliable information should be made available on actions related to *Mudaraba* funds. Making such information available is facilitated by the preparation of a *Mudaraba* standard based on sound controls. It is expected that this standard, which will ultimately lead to the preparation of a further standard will reflect the role of the Islamic bank as a *mudarib.*

A study conducted by AAOIFI (2002) revealed that there were differences within Islamic banks in the measurement and recognition of *Mudaraba* financing transactions. The study also revealed differences in the method of presentation and disclosure. Such differences in accounting treatment and disclosure thereof have several affects. Therefore, it may be difficult to compare the profits realised by one Islamic bank with those of another. This is likely to render the information produced by the Islamic bank less useful to users of its financial statements.

The *Mudaraba* standard issued by AAOIFI, therefore, shall apply to *Mudaraba* financing transactions carried out by the Islamic banks as providers of funds and transactions related to the capital provided to be used in this purpose. However, this standard does not address the following:

a) The accounting treatment of *Mudaraba* transactions in the mudarib (client) books as well as the *Mudaraba* books.

b) The Islamic bank's receipt of unrestricted investment account funds which are characterised as *Mudaraba* from a Sharia'h perspective.

c) The Islamic bank's receipt of restricted investment account funds whether in its capacity as *mudarib* or agent.

d) *Zakat* of *Mudaraba* fund.

Accounting treatment of *Mudaraba* financing

It is a *Sharia'h* requirement that capital should be known in terms of quantity and quality as this represents the basis of the value in which *Mudaraba* financing is presented in the Islamic bank's book. The capital should be paid in cash and may be in kind (trading assets) and its value at the time of contracting should be outlined as required by *Sharia'h*. The capital may also be in the form of non-monetary assets prepared for utilisation and the fair value thereof would be more reliable. However, there are two reasons for not using the historical cost basis to measure the non-monetary assets submitted by the Islamic bank as *Mudaraba* capital. These are:

- The use of the value agreed upon by the parties to the contract achieves one of the objectives of financial accounting provided for in the statements of objectives (para 36).

- The use of the value agreed upon by the parties to the contract to value the non-monetary assets leads to the application of the representational faithfulness concept provided for in the statement of concepts (para 112).

The use of the historical basis to measure the *Mudaraba* capital provided by the Islamic bank after contracting is one of the *Sharia'h* requirement rules of *Mudaraba* in terms of specifying the capital and its maintenance up to the time of the settlement of the accounting order to identify the profit (para 98).

4.5.2 *Musharaka* standard

Musharaka is a form of partnership between the Islamic bank and its client whereby each party contributes to the capital of the partnership in an equal or varying degree to establish a new project or share in an existing one, and whereby each of the parties becomes an owner of the capital on a permanent or declining basis and shall have the due share of profits. Losses are shared in proportion to the contributed capital. It is not permissible to stipulate otherwise. In other words, *Musharaka* is participation financing whereby the bank provides part of the equity and part of the working capital for the business, and shares profit and losses with other partners.

A study conducted by AAOIFI reveals that the average percentage of transactions in which *Musharaka* financing is used is 15%. The study also shows differences between Islamic banks in measuring and recognising *Musharaka* financing transactions as well as differences in their methods of presentation and disclosure. Such differences in the accounting practices and disclosure have revealed certain effects. The study states that it may be difficult to compare profits realised by one Islamic bank with those realised by another. This is likely to render the information produced by an Islamic bank less useful to the users of financial statements. The study also states that such differences may also affect the distribution of the results of joint finance transactions in terms of profit or loss between holders of unrestricted investment accounts and an owner's equity on one hand, and the allocation of profit or loss between holders of unrestricted investment accounts on the other hand (Accounting, Auditing and Governance Standards for Islamic Financial Institutions, 2002).

Hence, standardisation of the accounting treatment in order to recognise and disclose profits conforms with the provisions of the statement of objectives such as determination of the rights and obligations of all concerned parties, including those rights resulting from incomplete transactions and other events in accordance with the principles of Islamic business ethics. Standardisation also ensures that users of financial reports of Islamic banks can make considered decisions in their dealings with Islamic banks.

In other words, the *Musharaka* capital is governed by a group of principles, the most significant of which are: that the share of each partner should be known, specified and agreed as to it amounts at the time of contracting, the share of capital of each partner should be its amount at the time of contracting and the share of capital of each partner should be available at the time of contracting. This cannot be in the form of a debit in the account in order to avoid deception or misunderstanding and inability to make use of the capital. If the capital is in the form of real or intangible assets, *Sharia'h* principles require the valuation of the intangible assets by agreement of the partners, and the Islamic bank's share in the *Musharaka* shall be measured at a fair value at the time of contracting.

4.5.3 *Zakat* standard

Literally *Zakat* means blessing, purification, increase and cultivation of good deeds. It is called *Zakat* because it blesses the wealth from which it is paid and protects it. In *Sharia'h, Zakat* is an obligation in respect of funds paid for a specified type of purpose and for specified categories. This is a specified amount prescribed by *Allah* the almighty for those who are entitled to *Zakat* as specified in the *Qur'an*. The word *Zakat* is also used to indicate the amount paid from the funds that are subject to *Zakat.*

Reason for issuing the standard

The reasons for the standard can be attributed to the following:

1. Zakat is one of the five pillars of Islam and an ordinance performed by a Muslim in servitude and approach to *Allah* almighty. This rite is connected with the wealth of a Muslim, for in his performance thereof there lays

purification of his soul and growth and purity of his wealth. The preparation of a *Zakat* standard would help Islamic banks to perform this ordinance.

2. Differences exist in the methods used by Islamic banks in determining the *Zakat* base. These differences would not enable users of financial statements to compare the various results of Islamic banks in a manner that would help them in taking decisions.

3. The standardisation of the method used to calculate *Zakat* would help in providing useful information to users of financial reports of Islamic banks. The importance of such information stems from the fact that in the cases where the Islamic bank is obliged to pay *Zakat*, the accounting treatment of *Zakat* affects the determination of the Islamic bank's net income.

Conditions for liability to *Zakat*

As *Zakat* is levied only on the assets of those who are capable of paying it, certain conditions are laid out to its liability. These conditions are as follows:

a) Unencumbered possession. There is no *Zakat* on the property of the owner of who does not where it is, or is unable to dispose of it. Also there is no *Zakat* on public funds, or funds held for *Waqf* (endowment) for charitable purpose and the funds of charitable organisations.

b) Growth in real terms or by estimation. Growth by estimation may take place if the asset has the potential to yield a surplus and this includes cash and cash equivalent including gold and silver, even if they are not invested.

c) Attainment of *Nisab*. *Nisab* is the minimum amount not liable to the payment of *Zakat*. This means that there is an exemption of property from *Zakat*. The *Nisab* for gold is 85 grams and for silver is 595 grams. Cash and trading goods are estimated using their cash equivalent compared to the value of gold. For livestock, agricultural, and horticultural produce each category has its own *nisab* as explained in *Sharia'h*.

d) The passing of *Houl*. To calculate *Zakat*, one lunar year must firstly pass from the point of attainment of *Nisab*. The balance of funds at the beginning and end of the year is important to calculate *Nisab* and hence the amount of *Zakat* payable. Changes in the balance within the year are ignored. The *Houl* means a lunar year which is about 11 days less than the solar calendar. Hence, in the case of the solar calendar the rate of *Zakat* is increased to a rate of 2.5775% instead of 2.5% as ruled by the conference on *Zakat* held in Kuwait in 1984.

Valuation of trading assets

Trading assets should be valued for the *Zakat* purpose at their market selling prices (cash equivalent value) and not at the historical cost on the day when *Zakat* is due (AAOIFI, 2002). However, it is permissible to pay *Zakat* from the same goods if this makes things easier for the *Zakat* payer at time of recession or a lack of liquidity and at the same time serves the interests of those who are entitled to *Zakat* by taking goods from which they can benefit. *Zakat* varies according to the type of asset possessed:

- *Zakat* on debts owed by third parties (accounts receivable): in this type, *Zakat* is obligatory on accounts receivables which are acknowledged by debtors who are able to pay them.

- *Zakat* on debt (liabilities): only debt due to be payable during the year following the date of the statement of financial position should be deducted.

- *Zakat* on other types of assets: funds subject to *Zakat* are recognised and measured by calculation of *Nisab*, according to the nature of these funds, whether cash, livestock, agricultural and horticultural produce, trading goods or otherwise.

Methods of determination of the *Zakat* base

There are two methods used in calculating *Zakat* base:

First: the net assets method. According to this method, *Zakat* shall be calculated by using the following equation:

***Zakat* base** = assets subject to *Zakat* - (liabilities that are due to be paid during the year ending on the date of the investment of financial position + equity of unrestricted investment accounts + minority interest + equity owned by the government + equity owned by endowment funds + equity owned by charities +

equity belonging to not-for-profit organisations excluding those that are owned by individuals) (para3).

Second: net invested funds. *Zakat* base shall be determined as follows:

***Zakat* base** = paid-up capital + provisions not deducted from assets + retained earnings + net income + liabilities that are not due to be paid during the year ending on the date of the statement of financial position - (net fixed assets - investments not required for trading, e.g. real state for rent + accumulated losses) (para 7).

The two methods give the same numerical result. Accordingly, the Accounting and Auditing Standard Board has decided to give the Islamic banks the option to choose the method that is most appropriate for them and disclosure should be made of the method that has been adopted.

4.6 The extent of implementing AAOIFI standards

As stated earlier, without application of Islamic *Sharia'h,* the setting of Islamic Accounting Standards is impossible. The best way to implement AAOIFI standards in the various Muslim countries depends on the co-operation of Muslims accounting scholars and must be supported with financial resources.

The debate is how Islamic accounting can satisfy Islamic requirements; Triyuwono (2001) argues that Islamic accounting has a different theoretical background to conventional accounting and that a fresh approach needs to be considered. Consensus concerning how an Islamic financial institution should be expected to formulate an acceptable annual report, comprehensively detailing its compliance to *Sharia'h*, appears therefore to be some way off.

In addition, AAOIFI states some items concerning Islamic value information. These items need to be disclosed in the annual reports of Islamic banks:

1. Basic information about the Islamic bank.
2. Unusual supervisory restriction.
3. Earning and expenditure prohibited by *Sharia'h.*
4. The method used by the Islamic bank to allocate investment profits (loss) between unrestricted investment account holders or their equivalent and the Islamic bank as a *mudarib* or as an investor with its own funds.
5. Statement of changes in restricted investments.
6. Statement sources and uses of funds in the *Zakat* and charity fund.
7. Statement of sources and uses of funds in the *Al-qard* fund.

Karim (2001) notes some factors that contribute to the low implementation of AAOIFI's standards in the countries in which Islamic banks operate. These include, among others, the lack of appreciation by the relevant agencies that are responsible for enforcing accounting standards of the benefits that can be gained by implementing AAOIFI's standards, for example, comparability and transparency of financial statements of Islamic banks, providing users with relevant and reliable information.

Haniffa and Hudaib (2001) state that the AAOIFI standards have been proposed as a first step towards formulating specific Islamic banking standards through its conceptual framework of Islamic accounting and are not considered by many to be well prepared. They conclude that the extent and level of disclosure is still based on conventional requirements and not on Islamic accounting requirements e.g. the disclosure of lawful dealings, wages, the achievement business venture objectives and protecting the environment. These results coincide with Harahap's (2003) results who cite some issues resulting from applying AAOIFI disclosures, namely;

1. The AAOIFI does not require the disclosure of the supervisory opinion and report message of the Supervisory Board regarding the bank's operation.
2. The AAOIFI is very concerned with restriction on transactions, assets and investment based on *Sharia'h*.
3. The AAOIFI requires the disclosure of earnings and expenditure prohibited by *Zakat*.
4. The AAOIFI requires information concerning *Zakat* and *Alqard Hassan* to be stated.

Maali *et al* (2003) state that not all Islamic banks in Sudan followed the *Sharia'h* Supervisory Board (SSB) report form that suggested by AAOIFI. They also state that most Islamic banks did not provide *Alqard Alhassan* statements as required by the AAOIFI. However, Maali *et al* (2003) state the Islamic banks that follow AAOIFI standards tend to provide more social disclosure information than the non-compliant banks.

From the above, it can be seen that the low implementation of AAOIFI's standards may be attributed to several factors. The AAOIFI must therefore exert more effort to have its standards recognised by an increasing number of practitioners. These factors include:

1. The primary focus of AAOIFI was on issuing and promulgating standards (accounting standards, auditing standards, ethics code).

2. Neglecting gathering consensus among Scholars and Accountants to support and recommend its Standards.

3. Lack of authority in different countries to encourage Islamic banks to use the AAOIFI standards.

4. Lack of awareness among the users of financial accounting information about the importance of using Islamic accounting information.

5. Islamic banks should also seek to apply suitable accounting standards which provide their customers with relevant information to assist them in decision making.

6. As conventional banks seek to deal with Islamic financial institutions, they should apply suitable accounting standards to carry out their transactions. Traditional accounting standards, as stated by many scholars, are not suitable for Islamic finance. Therefore, they should look for standards based on *Sharia'h* law.

7. A lack of voluntary application may be attributed to the lack of using different instruments by the AAOIFI to announce their standards, a lack of funding and failure to hold conferences about the importance of its standards.

4.7 Summary

Accounting theory has developed over a long period. Therefore, it should be continually improved to respond to the changes in economic and social conditions and in response to the requirements of those end users of financial statements without necessarily affecting the relevant principles and postulates (Catlett, 1962). However, Islamic accounting is not yet an established accounting sub-discipline, but it is well on its way. Differences exist in the methods used by Islamic banks in calculating and determining some services produced by Islamic banks such as *Musharaka*, *Zakat* etc. These differences would not enable users of financial statements to compare the various results of Islamic banks in a manner that would help them in taking decisions. On the other hand, differences between AAOIFI standards and IAS illustrate that the Islamic banks should apply AAOIFI standards to obtain their objectives and satisfy their customers by taking them away from prohibited transactions.

Hence, developing unique accounting and auditing standards for the dissemination of accounting information about Islamic banks performance becomes a necessity. AAOIFI is a pioneer independent organisation in setting Islamic accounting standards based on *Sharia'h* law and Bahrain opened the way to apply such standards within the Islamic bank. However, when there are no specific standards, the Islamic financial institution may use standards other than those issued by AAOIFI as deemed appropriate, which do not contravene the *Sharia'h* Rules and Principles. The adoption date of the first accounting standard was deemed to be October 1993, and the effective date for financial statements was supposed to be the fiscal period beginning 1 January 1996. The adoption of the first auditing standard, however, was in the Board meeting held on 19-20 May 1996, and is effective for the financial statements for the fiscal period beginning 1 January 1998. The adoption of the first governance standard was on 16 June 1997 and is effective for the financial statements for the fiscal period beginning 1 January 1999.

It is time to make room for the new accounting standards to take their role in regulating and formatting the Islamic accounting information to meet their users' needs and fulfil the objectives of the society in which Islamic banks operate. The next chapter discusses the methodology used to examine the AAOIFI standards that are applied by Islamic banks operating in the State of Bahrain.

Chapter Five

Research design and data collection

5 Introduction

The literature review concluded that most traditional accounting standards are inconsistent with Islamic financial institutions in general and Islamic banks in particular. Accordingly, Islamic financial institutions should seek alternative accounting standards which are based on *Sharia'h* precepts and meet the need of the users of financial information. The Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) was established to respond and fill the gap in this area. Islamic banks operating in Bahrain are applying AAOIFI standards. The obligation with such standards became compulsory in 1999.

The development of accounting standards specifically for Islamic banks and financial institutions is intended to provide a uniform and consistent basis for preparing the financial statements of entities operating in this industry; meet users' needs for accounting information to assess business performance and investment risk; and present a clear view and understanding for the preparers of financial statements of Islamic financial organisations.

Accordingly, the purpose of this chapter is to explain the methods used to meet the study's objectives. This study aims to investigate empirically the usefulness of the annual reports of Islamic banks prepared in accordance with the accounting standards that have been issued by AAOIFI as an alternative to conventional accounting standards. This chapter identifies the main research methods used in this study to investigate the impact of AAOIFI standards on the financial report of

Islamic banks in Bahrain. A consistent method is adopted to meet the research objectives. A content analysis for the annual reports of Islamic banks has been undertaken as the first stage. A survey by questionnaire, as the second stage, is conducted in this study. The two methods are viewed as complementary to each other and the strengths and weaknesses of each method are considered. The following section provides information on the designing of questions, pilot testing and the problems encountered during administration of the questionnaires. The next section comprises details of the sample selection and size and details of statistical tests used to analyse the questionnaires. Finally, a summary of the chapter is provided.

5.1 Research design

According to Bryman and Cramer (1997) there are two main types of research design: experimental and survey/correlational design. In the experimental design, it is possible to control and manipulate the variables of interest by having a control group and varying the treatment or stimulus. It is also possible to control the sequencing of the treatment or stimulus i.e. their time order. This is important in establishing cause-effect relationships, which can not only be used to explain phenomenon, but to predict and control future occurrences.

In the survey/correlational design, which is adopted in this study, the researcher is unable to control and manipulate variables; for instance, it is impossible to control the education or the working experience variables of the population sample in this study (the users of financial statements of Islamic banks). On the other hand, the survey design can reveal relationships between variables although it is limited in its capacity to elucidate casual processes. These relationships can, however, be spurious as another unidentified variable may cause both these variables to move with each other. This cannot be controlled in the experimental design. The relationship can of course be otherwise purely circumstantial. The spuriousness or otherwise of relationships between variables can be tested by using multivariate techniques.

This research is mainly exploratory in nature and seeks to explore the impact of the AAOIFI standards on the financial reports of Islamic banks amongst those who are using these financial reports in decision-making. It is more concerned to survey different users' perception towards the alternative standards used in preparing the financial statements of the banks. Accordingly the investigation starts by using the content analysis for the published annual reports of Islamic banks to discover the lack or shortfall in applying the AAOIFI standards. To achieve this objective, a comparison between two annual reports prepared in accordance with different standards has taken place as explained later.

Research data may be categorised as primary and secondary data. Primary data is data generated by the researcher using data gathering techniques. Secondary data is that which has been generated by others and is included in data-sets, case material, computer or manual database or published by various private means (e.g.

annual reports of companies, public organisations or government departments etc) (Hameed 2000).

In this research, primary data is used as one way of extending knowledge in Islam by asking those who are knowledgeable in the finance field and to seek their views. It is most useful to ask those who are interested in dealing with Islamic banking about the need for a specific Islamic accounting system that should be emerging from the root of Islamic *Sharia'h* (*Qur'an* and *Sunnah*). As Islam is a way of life, not merely a religion, it is important for its adherents to manage natural resources in a way appropriate to its authority. Accordingly, it is important to survey professional groups such as accountants, financial analysts, auditors, etc, to record their perceptions of the optimal accounting standards that should be followed by Islamic banks to fulfil their objectives in which they operate. Primary data needs to be gathered. Two methods are conducted: the first method is content analysis which is based on financial reports of Islamic banks to uncover any shortfall in the application of AAOIFI standards. The outcome of using this instrument is revealed in the next stage by using a questionnaire.

5.2 Identification of the research problem and the empirical study objectives

There are several issues pertaining to accounting matters with reference to Islamic banks which merit discussion, for example, uniformity in accounting measurement methods and reporting. The importance of these issues stems from the fact that the annual reports produced by the Islamic bank must be comparable and easy to understand by users. A good annual report can be an effective communication vehicle to inform internal and external users besides being a marketing tool to sell the company in the market (Dunk, 1995).

The person or body who should regulate the accounting information is discussed by Idris (1996). He expected the newly formed AAOIFI to successfully achieve reliability, comparability, uniformity, and consistency in accounting information for Islamic financial institutions. Several attempts have been made to achieve this; some of these studies were discussed as part of AAOIFI's objectives and standards. For example, Pomeranz (1997) called for specific accounting standards that fulfilled the objectives of Islamic financial organisations; Al- Hajji, (1999) studied the accounting treatment of *Ijara* contract by Islamic banks in the GCC.

Therefore, this study is an attempt to explore the role of AAOIFI accounting standards in developing Islamic accounting standards and motivating Islamic banks to achieve their objectives toward the society in which they operate. Bahrain was chosen for the purpose of the study because the country is hosting the organisation that is issuing and supervising the Islamic accounting standards. it leads the Islamic finance environment in the gulf region and the implementing of AAOIFI accounting standards has been compulsory by the Islamic banks operating therein since 1999.

Because of the importance of the subject, it was decided to use two different types of research methods. The aims of this research were to:

1. Investigate and explore the perceptions of those who prepare and use financial statements of Islamic banks in Bahrain towards the kind of accounting standards and the regulation used in preparing these statements.

2. Investigate whether the implementing of the AAOIFI's standards in preparing the financial statements of Islamic banks is sufficient to provide users of such statements with the information they need.

3. Investigate whether or not Islamic accounting regulations are welcomed amongst the users' of financial statements of Islamic banks and decide who should regulate them.

4. Discover if the users of financial reports of Islamic banks believe that the AAOIFI is a suitable body to set Islamic accounting standards.

5. Explore whether the recent annual reports of Islamic banks have been prepared adequately in accordance to the AAOIFI standards and whether they fulfil the AAOIFI's requirements in particular.

6. State whether the recent financial statements of the Islamic banks are relevant, reliable and contain sufficient disclosure.

5.3 Data gathering techniques

5.3.1 Content analysis

NOAA (2004) identifies the content analysis as an instrument used for text analysis and it uses interviews, transcripts, newspapers, books, manuscripts, and websites to determine the frequency of specific words or ideas. This study used content analysis to determine the extent of the use of accounting standards in preparing financial statements. In other words, the aim behind using this instrument is to analyse the annual reports to discover which accounting standards have been used in preparing such statements in two different years. The result of the content analysis allows researchers to identify, as well as quantify specific ideas, concepts, associated patterns and trends of ideas that occur within a specific group or over time.

As a part of this study's methods, content analysis is used to carry out specific ideas pertaining to the annual reports of Islamic banks and to explore and examine a certain side of the study based on it. This instrument is considered as a base to establish and design part of the questionnaire. The study seeks to establish whether these banks are using the AAOIFI accounting standards in preparing their financial statements and the extent of such compliance. Evidence of implementing AAOIFI standards was sought through examining the annual reports. Banks may produce and use other documents throughout the year containing information referring to the application of the accounting policy that has been used in preparing such information.

In order to conduct the content analysis, it was decided to examine and analyse the annual reports of the sample for two years (1997, 2002). The year 1997 was chosen because it was the last year before AAOIFI standards became applicable for Islamic banks. 2002 was the latest available year to obtain annual reports of Islamic banks that when this study took place. Moreover, the AAOIFI issued its accounting standard No 11 which became effective from 01. 01. 2001.

The initial population for this study comprised all Islamic banks that are members at the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) in the GCC. After reviewing most of the annual reports of Islamic banks operating in the region, it was discovered that only Islamic banks operating in Bahrain were applying the AAOIFI standards. At present, there are 26 Islamic banks and financial institutions operating in the State of Bahrain and offering Islamic finance. However, only 12 are members of the organisation (AAOIFI, 2004). 5 out of the 12 were established after 1997 such as Gulf Finance House 2001, Kuwait Finance House-Bahrain 2001. The remaining Islamic banks which fulfil the analysis requirement are 7 Islamic banks.

An extensive effort has been made to collect data (annual reports) from the 7 banks. E-mails were sent to the banks requesting a copy of their annual reports for the two specified years (1997, 2002) to enable the researcher to analyse the content of such reports. A search through the internet has also been made to discover whether these banks are members of AAOIFI and applying its standards.

More than 10 annual reports have been received, all the available websites were displayed, After reviewing the bank's annual reports, it was found that only 4 Islamic banks can be included because they are fully commercial and are applying AAOIFI standards.

5.3.1.1 Designing of content analysis

To conduct the content analysis, an appropriate form was designed. This form is used to examine and analyse the annual reports of the sample for two years (1997, 2002). This form is divided into the following sections:

Section one: General information about banks

This section contains general information about the main sections contained within the annual reports of Islamic banks such as whether annual reports contained the *Sharia'h* Supervisory Board (SSB) report, whether the annual report outlined the kind of services offered, and whether the experience of the banks is explained. It is intended to analyse this part of the annual report to discover differences through comparing the fundamentals of Islamic banking in two given years. It also attempts to identify the additional information that has been included after applying the alternative accounting standards.

Section two: Analysing the auditor report

The purpose behind issuing auditors reports is to provide a clear written expression and an independent opinion on the financial statements. This report should contain the basic elements which are; title, address, opening or conductor paragraph, scope paragraph, reference to the relevant accounting standard, description of the work the auditor performed, opinion paragraph, auditor address, and the auditor's signature (AAOIFI, 2002). In this study, analysing this section reveals whether the external auditors of Islamic banks refer to the requirements that should be applied in preparing their financial statements, and whether these banks abide by using specific accounting standards, and which accounting standards they followed in preparing their financial statements. Furthermore, the analysis reveals whether the final form of auditor report contains the main requirements such as addresses, signatures, dates, etc.

Section three: Analysing the *Sharia'h* Supervisory Board (SSB) report

Any Islamic bank must have the *Sharia'h* Supervisory Board, or Committee, which is composed of religious authorities that ensure all bank practices confirm with the letter as well as the spirit of Islamic teaching. Therefore, in order to ensure that the practices and activities of Islamic banks do not contradict the Islamic ethical standards, Islamic banks are expected to establish a *Sharia'h* Supervisory Board, consisting of Muslim jurisprudence, to act as advisers to Islamic banks.

According to the requirements of this report, AAOIFI emphasised that the annual report should contain the SSB report. The SSB report should contain; title, address, opening introductory paragraph, scope paragraph describing the nature of work performed, opinion paragraph, date of report and signature of the members of *Sharia'h* Supervisory Board (AAOIFI, 2002). The analysis conducted by this study investigates whether the published annual reports of Islamic banks refer to the existence of the SSB reports, whether the report raises issues about the nature of the banks' activities and to what extent these activities meet with Islamic *Sharia'h* in particular, and whether these reports refer to prohibited transactions and how the bank disburses the non-Islamic income. All these issues and others should be demonstrated in the SSB report which is regulated by AAOIFI.

Section four: Analysing the content on accounting policies

Accounting is often referred to as the language of business. No doubt accounting must change to respond to the changes in economic conditions. However, Solomons (1991) believes that accountants are like journalists and they should report the news not make it. The annual reports should enclose notes to the financial statements to reveal polices used in preparing such information. This section identifies the important aspects that should exist in the annual reports of any organisation. For example, the accounting standards followed in preparing financial statements, the method used in evaluating assets, the disposal of non-Islamic income, referral to social responsibility, etc. By comparing 1997 and 2002, it can be observed which accounting standards that the Islamic banks apply in preparing their financial statements and the extent of AAOIFI standards implementation.

Section five: Analysing the nature of banks' activities.

This part of the analysis focuses on the banks activities and the return produced from these activities. The extracted result may show whether the banks channelled their funds into products which fit with Islamic *Sharia'h* law. In more detail, this section investigates the banks' transactions, for example, whether the bank is channelling its funds into Islamic finance and whether it discloses how it shares its profit and loss with the investment account holders and how it disburses non-Islamic income etc.

5.3.1.2 Content analysis sample (annual reports of Islamic banks)

The annual reports of Islamic banks are taken as one of the resource data in this study. They are investigated to examine and explore the applicable accounting standards followed when preparing their financial statements. The scope of this analysis covers the following Islamic banks in Bahrain:

1. Bahrain Islamic Bank.
2. ABC Islamic Bank.
3. Al-Baraka Islamic Investment Bank.
4. First Islamic Bank.

These Islamic banks are chosen as a sample for this study for several reasons:

- These banks apply AAOIFI standards.
- All these banks finance Islamic services and full commercial banks.

- These banks have large financial assets, cover different areas, inside and outside Bahrain.
- These banks applied different accounting standards in preparing their financial statements in the two years which have been chosen for the analysis.
- The annual reports of these banks have been collected for two years (1997 and 2002).
- These four banks fulfil the study requirements.

5.3.2 Questionnaire

According to Babbie (1990, p.135) "questionnaires are a good way of collecting certain types of information quickly and relatively cheaply". The purpose of questionnaires is to collect data that can be converted into measures under investigation. They are mainly descriptive studies which gather a broad spectrum of information on facts, beliefs, opinions, knowledge, attitudes and experiences. Czaja et al (1996) proposes three conditions which should be met in order to use a questionnaire:

1. The target group who will receive the questionnaire should be clearly defined and identified.
2. The majority of the respondents will understand the information asked of them.
3. The general focus of the analysis should be numerical.

With regard to the design of a questionnaire, Jankowicz (2000) identifies three requirements that should be met:

1. It is important that questions should be clear and easy to understand.
2. The layout of a questionnaire should be easy to read and pleasant to the eye.
3. The questionnaire should be developed in an interactive way.

A structured questionnaire is the ideal method for obtaining information from large numbers of diverse people and is relatively quick and cheap to manage (Hakim, 2000). A self-administrated, questionnaire is the best technique for collecting data when dealing with a survey that is confined to a local area. This method of data collection ensures a high response rate within a short period of time. Using this method also provides an opportunity to introduce the research topic and motivate individuals to participate in the survey. Another advantage associated with the self-administrated questionnaire is that it is less expensive and less time-consuming than interviewing and it requires fewer skills to administer than to conduct interviews (Sekaran, 1992).

The questionnaire is a highly structured data collection technique whereby each respondent is asked the same set of reformulated written questions. A questionnaire can be carried out either by mailing it to respondents or by personal administration whereby the questionnaire is presented to the respondents with explanations of the purpose of the inquiry, and then the respondent is left alone to complete it. This will be discussed later (Oppenheim 1992). With regard to the usefulness of the information provided in financial statements, the questionnaire survey has been used in several previous studies such as; Lee and Tweedie (1976), Anderson (1981), Change and Most (1985), Ahmed (1988), Owaidan (1994), Idris (1996), Almubarak (1997), Alhussaini (2001).

Moreover, this technique has the following advantages: Oppenheim (1992):

1. It gives useful background information.
2. It is reliable and can be administered before and after an intervention.
3. It covers a large number of samples.
4. It avoids bias by an interviewer.

However, Newman (1997) states that the questionnaire has certain disadvantages as follows:

1. Response rate may be low.
2. A researcher cannot control the conditions under which the questionnaire is completed.
3. Its format limits the kinds of questions that a researcher can use.

Nevertheless, these disadvantages are not inevitable or incapable of being overcome. These difficulties can be wholly or partially overcome by the following (Al-Hajji, 2003):

1. Good administration skills to reduce bias, increase response rate and keep the process in line with the objectives of the study.

2. Good planning and effective questionnaire design increasing effectiveness, reducing costs and simplifying the analysis of results.
3. Personal contacts with these institutions facilitating the research process.
4. The researcher covers all the study population.

5.3.2.1 Questionnaire objectives

The main objective of this questionnaire is to collect data from those who are using annual reports of Islamic banks in Bahrain to investigate their perception toward the adequate standards used in preparing such annual reports and the usefulness of the information contained for their decision making. Additionally, surveying the extent of reliability, adequacy, and sufficiency of information published in such reports.

5.3.2.2 Questionnaire construction

Many text books explain the methods of constructing questionnaires and scales. Openheim (1992) states two main different types of questionnaire: a closed-ended questionnaire, and an open-ended questionnaire. The advantage of closed-ended questions is that they are easier and relatively quicker to answer. Closed-ended questions also can be administered with little direct confrontation (Schuman and Presser, 1979). The Likert Scale is a method designed to measure people's attitude and it is intended to elicit useful responses to an enquiry. It is good in predicting objective voting intentions as compared with other scales (Nachmias and Nachmias, 1992). Respondents were asked to express their opinion on a number of statements by using a five point Likert Scale ranging from strong agreement at 5 through to strong disagreement at 1.

In this study, the closed-ended questionnaire is useful to facilitate and accelerate the respondents of the participants. The questionnaire in this study is divided into two main parts; the first part contains general information about the participant such as age, expertise, education, gender etc; and the second part comprises specific information relating to the main subject which investigates the applicability of AAOIFI standards by Islamic banks and the comprehensibility and usefulness resulting from applying such standards by surveying users (internal & external) of financial statements of Islamic banks. This part is divided into three sections. Each section answers part of the research questions. The following provides more details about these constructions.

Part one: The participant

The aim in this section is to recognise the main characteristics of the participants contained within the sample. It is important for the purpose of this study to involve those who have a direct relationship with the published financial statements. The researcher seeks to include different categories in the survey to obtain credibility and objectivity. This section aims to answer research question one.

Part two, section one: the need for regulating accounting information and responsibility for the regulation.

This part investigates the perception of participants toward the importance of the source of financial information and of the need for regulating accounting information. It asks who has the authority to regulate such information. This section aims to answer research question 2. This section is represented in the following questions:

	1	2	3	4	5
In making transactions with Islamic bank, how do you rate the following information sources? • Bank annual reports • Bank interim reports (quarter annual report) • Direct information from bank • Newspaper and business magazines • Government publications and statistics • Market's rumours • From friends advice • Specialised publications (e.g. stock exchange market report& chamber of commerce report)					
Do you think that the accounting information for Islamic banks should be regulated? Yes ☐ No ☐					
If you answered "Yes" to the above question please indicate your opinion on accounting standards in Islamic banks from the options below. • Accounting standards should be set by the public sector • Accounting standards should be set by private sector • Accounting standards should be set by public & private sector					

Part two, section two: The perception of users of financial statements toward applied accounting standards.

The aim of this section is to survey the participants' knowledge about the existence of AAOIFI as an organisation interested in setting Islamic accounting standards. This section answers research questions 3, 4, and 5. The suggested questions are as follows:

Do you think that the accounting information for Islamic banks should be regulated? Yes ☐ No ☐					
Do you think that the AAOIFI is qualified to establish accounting standards? Yes ☐ No ☐					
Have you got any idea about the applicable accounting standards in the bank you deal with? Yes(answer ques. 8) ☐ No (answer ques. 9) ☐					
	1	2	3	4	5
If yes, which accounting standards does your bank apply? • International Accounting Standards Board (IASB). • Accounting and Auditing Organisation for Islamic Financial Institution (AAOIFI). • Local Accounting Standards Board.					
If no, which of the following accounting organisation do you think should regulate the accounting information? • International Accounting Standards Board (IASB) • Accounting and Auditing Organisation for Islamic Financial Institution (AAOIFI). • Local Accounting Standards Board.					
Which of the following aspects should be considered when dealing with Islamic banks? • Reputation of Islamic bank. • Applying AAOIFI standards. • Its name contains an Islamic word. • Performing high ratio of profit. • Producing only Islamic productions.					
What are the main factors motivating customers to deal witb Islamic banks? • Following *Sharia'h* precepts. • Its name contains an Islamic word. • Application of the AAOIFI standards. • Reputation of Islamic bank. • Performing high ratio of profit. • Existing in different areas (many branches). • Periodic distribution of profits. • Service quality.					

Part two, section three: examination of the Application of the AAOIFI standards

This section is formulated to survey the participants' familiarity with the accounting standards applied in preparing the financial statements of Islamic banks. In addition, the shortfall resulting from applying such standards which is extracted from the first instrument (content analysis) is examined. This section is designed to answer study questions 7 and 8. The following questions examine the users' perception toward AAOIFI standards.

	1	2	3	4	5
Please state the level of importance of the following items contained within the annual report? • The importance of calculating provision and reserves on the impairment assets. • Referring to the method of calculating provisions. • Referring to the treatment of impairment assets. • Referring to the amount of impairment assets. • The level of disclosure about the provisions.					
Please state the importance of the following information in the *Sharia'h* Supervisory Board report (SSB). • The importance of preparing the report. • Referring to ex ante auditing the contracts. • Referring to the treatment of clients insolvencies. • Referring to sources of non-Islamic income. • The level of disclosure in the SSB report.					
Please state the importance of the following information about Zakat statement. • The importance of preparing the statement. • Referring to how *Zakat* is calculated. • Referring to the sources of funds. • Referring to the uses of funds. • The level of disclosure.					
Please state the importance of the following information about *Al-Qard Al-Hassan* statement. • The importance of preparing the statement. • Referring to the sources of funds. • Referring to the uses of funds. • The level of disclosure. • *Sharia'h* Supervisory Board's report. • Auditor report. • Balance Sheet.					

• Income Statement. • Statement of cash flows. • Zakat statement. • *Al-qard Al-hassan* statement. • Statement of changes in unrestricted investment.					
Please state the importance of the following information in the *Sharia'h* Supervisory Board report (SSB). • The importance of preparing the report. • Referring to ex ante auditing the contracts. • Referring to the treatment of clients insolvencies. • Referring to sources of non-Islamic income. • The level of disclosure in the SSB report.					

Part two, section four: The general impression about the annual reports after applying the AAOIFI standards.

This section examines the users' impression toward information published in annual reports of Islamic banks and its usefulness in decision-making after applying AAOIFI. This section attempts to answer research question No 9. The following questions are asked:

	1	2	3	4	5
Which of the following aspects should be considered when dealing with Islamic bank? • Reputation of Islamic bank. • Applying AAOIFI. • Its name contains an Islamic word. • Performing high ratio of profit. • Producing only Islamic productions.					
What are the main factors motivating the customers to deal with Islamic banks? • Following *Sharia'h* precepts. • Its name contains an Islamic word. • Application of AAOIFI standards. • Reputation of the Islamic bank. • Performing a high ratio of profit. • Existing in different areas (many branches). • Periodic distribution of profits.					
Does the time lag between the closing date of the accounting period and the publishing					

of the statements effect decisions making? Yes ☐ No ☐					
In general, do you think that the following parts of the annual report have sufficient disclosure? • Chairman's report. • *Sharia'h* Supervisory Board's report. • Auditor report. • Balance Sheet. • Income Statement. • Statement of Changes in Shareholders' Equity. • Statement of cash flows. • *Zakat* statement. • *Al-qard Al-hassan* statement. • Notes to the financial statements.					
To what extent do you think that the bank abides by the accounting standards used? Excellent ☐ Very good ☐ Middle ☐ bad ☐ Very bad ☐					
To what extent do you think that the annual report fulfils the dealers' needs Very satisfied ☐ Satisfied ☐ Middle ☐ Unsatisfied ☐ Very unsatisfied ☐					
How likely are you recommend relatives and friends to deal with Islamic banks Strongly recommend ☐ recommend ☐ No opinion ☐ Recommend against ☐ Strongly recommend against ☐					

5.4 Methods and their rationale

5.4.1 Data collection from ideal to reality

The original intention was to divide the data collection into two parts; data collected from annual reports of Islamic banks from certain banks and data collected from distributed questionnaires. Unfortunately, the Islamic banks operating in the State of Bahrain do not fully apply the AAOIFI standards even after being required by BMA regulation to shift from applying conventional standards to their standards in 1999. AAOIFI has published some of its standards after that date. This made banks unwilling to follow AAOIFI standards before that date. Accordingly the year1997 and 2002 have been chosen to uncover any occurred shortfall resulting from applying the alternative accounting standards. Appraising the effectiveness of AAOIFI standards on the quality of financial reports of Islamic banks may be better gained by using questionnaires which are distributed among different groups of annual reports users. It is important that the information contained within the annual reports of Islamic banks must be understandable, relevant, punctual, credible and comparable.

5.4.2 The choice of Bahrain as the research environment

This study is an exploratory study of AAOIFI accounting standards. It is intended to investigate the usefulness of financial reports that have been prepared in accordance to such standards in decision-making. As outlined in details in chapter two, Bahrain is a suitable country for this study because Bahrain is the leading international financial centre in the Gulf region; The Kingdom of Bahrain pursues a dual banking system, where Islamic banks operate side by side with their conventional counterparts. Bahrain is also hosting the AAOIFI and other institutions that are concerned with the Islamic banking such as GCIBFI. Bahrain provides an attractive base for industry due to its tax-free environment. It has a stable currency, well developed infrastructure, low energy and operating costs and it has good road, sea and air link to major regional markets.

Moreover, the Islamic banking and finance industry in Bahrain encompasses a unique blend of institutions of different categories. Some are dedicated fully to providing Islamic banking services; examples of these are Bahraini Islamic banks, the Shamil Bank of Bahrain and Albaraka Islamic Bank. Other Islamic banks are resident banks which were originally undertaking conventional banking activities and have now converted to Islamic banks. The Arab Banking Corporation is a notable example of this. A final category of Islamic banks operating in Bahrain is represented by major multinational banks. A good example here would be Citi Islamic Investment Bank (a subsidiary of Citicorp).

In addition, the Kingdom of Bahrain is a suitable place for the research project because Bahrain is considered the country in GCC with the most Islamic banks; the country is one of the most economically free countries in the world; the country provides an attractive base for the Islamic banking industry; and the country is leading the international financial centre in the Gulf region (Bahrain Monetary Agency, 2002). In addition, the researcher comes from the Arabic region and hence language, communication and logistical problems, which may have been encountered if the researcher were working in non-Arabic countries, were reduced.

5.5 Population and sample statistics of surveyed participants

In Bahrain, there are 26 Islamic financial institutions providing different types of Islamic services and productions. 4 are full commercial Islamic banks, 3 are offshore Islamic banking units, 16 are investment Islamic banks, 1 is a representative office and investment advisors/brokers, and an Islamic infrastructure fund. Some of these are owned by local government, others are partly or totally owned by foreigners. Islamic banks employed a total of 834 people at the end of 2001 of which 91% were Bahraini and the majority of them have conventional banking experience (BMA, 2002).

It is worth looking at some of the possible items that financial statements could include in order to provide useful figures to people about their resources. Therefore, it is necessary to establish who the users are and what sort of information they might need. In this respect, the study specifies two groups of participants for investigation: internal users and external users of annual reports.

5.5.1 Internal users

This group comprised different categories of staff in the Islamic banks that have a direct relationship with the applied accounting standards. This group includes at the highest level the board of directors, chief executives, SSB members, internal auditors, at the median and lowest level, accounting department staff, and others who have a relationship with preparing any information included in the annual reports. 7 Islamic banks were involved in this study operating in Bahrain. They are; Albaraka Islamic Bank, ABC Islamic Bank, Bahrain Islamic Bank, First Islamic Bank, Kuwait Finance House, Albank Ashamil, and Citigroup (Citi Islamic Investment Bank).

This group consists of the following participants:

a. The Board of Directors, *Sharia'h* Supervisory Board members, directors, general mangers, chief executives, and internal auditors in the 7 Islamic banks. These participants comprise the high level management in Islamic banks. The targeted participants are about a quarter of internal groups.
b. The preparers of financial statements such as employees in the accounting department, employees of the bank operation department in Islamic banks.

130 questionnaires were distributed randomly among the group of internal users, the capacity of each bank has been considered when distributing the questionnaires. The greatest proportion was the other banking department; 100 questionnaires were distributed to this group. The targeted participants of other departments of users are about a three quarter of internal groups. Table 5.1 shows the distribution of the questionnaire among internal users of financial reports:

Table 5.1: distribution of the questionnaire "internal users"

Bank	No, of highest level	Other department	Total
• ABC	5	15	20
• Al-Baraka	5	20	25
• Bahrain	5	15	20
• First	5	15	20
	20	65	85
• Shamil	5	15	20
• Kuwait	5	15	20
• Citi	-	5	5
	10	35	45
[redacted]			

5.5.2 External users

The second group of the sample is the external users who belong to organisations that have an indirect relationship with the applied accounting standards in Islamic banks. This group comprises the Bahrain Monetary Agency (BMA) as a supervision agency, the Stock Exchange as a market of securities for Islamic banks, the General Council of Islamic Financial Institutions (GCIFI) which represents guidance for Islamic banks, the Bahrain Institution for Banking & Finance (BIBF) as an expertise organisation, Ernst & Young and Pricewaterhouse as external auditors of Islamic banks and the shareholders of Islamic banks. Table 5.2 shows the distribution of questionnaires among the external users:

Table 5.2: Distribution of the questionnaire to external Users

Organisation	No, of distributed Q
BMA	30
Stock market	25
External auditors:	
Ernest & Young	20
Pricewaterhouse	20
BIBF	30
GCIFI	5
Shareholder	20
Total	**150**

For more details, the targeted samples in this group comprised the following members:

Government representatives and external supervision

This section of external users demands accounting information for the purpose of calculating tax as well as economic planning (Naser 1993). One of the basic competences of Bahrain Monetary Agency (BMA) is controlling the liquidity in the market and applying the fiscal policy. Such users demand information to ensure Islamic banks comply with these requests. It therefore seeks the opinion of government officials about the sort of information published in the annual reports of Islamic banks. Thirty five questionnaires were distributed randomly among the BMA and GCIFI employees.

Shareholders

This category includes existing and potential shareholders. Shareholders are seen as an important group because of their regulatory financial information need about the financial position of Islamic banks. Al-Razeen et al (2004) state shareholders perceive that the annual report to be the most important source of information. However, the interim report was reported to be significantly more important to both the individual and institutional investors than it was to the creditors and governmental officials. In addition, the valuable opinion which members of this group may have about the use and usefulness of information published in the annual reports is sought. 20 questionnaires are distributed among this category.

External auditors

To assess any firm's performance and to compare the underlying accounting methods with benchmark methods chosen by the authorities responsible for setting accounting standards, auditing should take place to confirm and evaluate the performance of management. External auditors are expected to have specialist knowledge about the accounting standards used in preparing financial statements of any firm. Ernest & Young and Pricewaterhouse are specialised in auditing Islamic banks in Bahrain. Accordingly, forty questionnaires (20 each) were distributed randomly to these companies.

Stock market dealers

Other important users of information published in the annual reports of Islamic banks are the stock market brokers. Islamic banks listed in the Bahrain Stock Exchange (BSE) have to comply with a set of requirements before being provided with their listing status. Some of these requirements relate to the use of accounting standards in preparing financial statements of such banks. Hence, one of the main tasks of stock market brokers is to ensure that Islamic banks are applying acceptable accounting standards that fit with the BSE requirements. Thus, this group of users is expected to extensively use the annual reports and they are in position to provide a credible opinion about certain aspects of the reports. 30 questionnaires were distributed to this group.

Academics and researchers

The choice of academics and researchers in the area of business and finance, as one of the targeted groups for this study, is based on the grounds of their specialist knowledge. Academics are expected to undertake scientific research that covers different aspects of Islamic banks activities. Therefore, it was assumed that these users were in a position to provide credible and neutral opinions about the financial information the annual reports contained because they are qualified enough to give an objective judgement about the information contained therein. The Bahrain Institution of Banking and Finance (BIBF) is one of the targeted groups in this study because this institution provides contemporary training and education in the areas of management and leadership, banking, Islamic banking, insurance, accounting and finance and information technology. In addition, surveying this group was not restricted to the BIBF; there are other academics and researchers who are involved in this study. Table 5.3 below summarises the internal and external targeted groups and the distribution of the questionnaire.

Table 5.3: Distribution of the questionnaires to users

	Group (1)	Group (2)	Total
Internal user:			
• Board of directors and SSB members	30		30
• Other banking department employees	100		100
External user:			
• Government representatives		30	30
• Shareholders		20	20
• External auditors		40	40
• Stock market brokers		25	25
• Academics and researchers		35	35
Total	130	150	280

5.5.3 Pilot study

Oppenheim (1992) states that the pilot study is fruitful when each survey questionnaire presents its own problems and difficulties before it reaches the final draft, questionnaires have been composed and tried out, improved and then tried out again, often several times over until it is certain that they can do the job for which they are intended. Once the questionnaire has been prepared, the next stage is to test or pilot it to look for its weakness and inefficiencies. It should be tested on a selection of the targeted population and in the light of the results modification should be made. In other words, the purposes of the pilot study were: to design the questionnaire in its final form, and to identify any problem which is likely to arise during the field work stage (Mustafa 1989). By these means the data collected will be as accurate and reliable as possible.

In this study and because of the obstacles encountered when testing the questionnaire among the targeted groups, the identification of an alternative qualified group to survey their opinion toward the final form of the questionnaire is necessary. The suggested groups are:

- First, the business school academic staff (5 members of staff). Questionnaires were distributed to obtain their opinion on the wording sequence and structure of the questionnaire.
- Second, 5 colleagues all of them studying for a PhD in accounting departments. A set of questionnaires was given out to colleagues in different universities in the UK seeking their advice and observations.

Based on the feedback from the two sets of pilot test subjects, several modifications were made to the wording of some questions, some less important questions were deleted to reduce the length of the questionnaire, and some of the questions were reorganised to ensure understandability and sufficiency. When the final version of the questionnaire was ready for administration, it was translated into Arabic. There are several ways of administering questionnaires, such as personally or mailing it to the respondents, or by using electronic mail (Sekaran, 1992). However, in this study personal administration for distributing and collecting questionnaires is used.

5.5.4 Distributing and collecting questionnaire

In this study, a personal administration of the questionnaire was conducted with participants, usually at their workplace. The aim behind this method of distribution is to receive a fast response compared to the postal method where the participant might postpone or fail to complete it. The advantages of the personal handing method as stated by Hameed (2000a) include: doubts regarding the meaning of the questions can be clarified to ensure right understanding; the importance of the research can be personally presented to the participants and its significance explained to them to motivate honest answers by emphasising their contribution to the research; it requires fewer skills than interviewing and hence relatively low skilled assistants can be recruited to perform this task to speed up the research; and it ensures a better response rate because there is a personal face to the questionnaires and personal persuasion usually increases interest.

However, the disadvantages of this method seems to be that the researcher may introduce his personal bias by giving facial or verbal expressions, which may put the participant at unease. Further in explaining questions differently to different questioners, participants may be in fact answering different questions as compared to those whom the questionnaire was mailed. This survey is restricted to the Islamic banks that operate in Bahrain and other organisations that had a relationship with Islamic banks during the period August to December 2004.

The questionnaire is used in order to gather data on the perception of participants on the applicability, reliability, adequacy, and sufficiency of AAOIFI standards in preparing financial statements of Islamic banks operating in the State of Bahrain. The questionnaires were distributed either directly to the respondents or to the supervisors of employees in the chosen banks. Within two weeks, some of the answered questionnaires are collected, thereafter, an authorised employee promised to collect the rest of the questionnaires and send them to the researcher. The total numbers of distributed questionnaires is 280 of which 114 are collected. Table 5.4 below shows the responses rate to the survey:

Table 5.4: Questionnaire response rate

Condition	Total population	size of sample	distributed Ques	Total returned Q	% returned Q
Category 1: Internal users					
• **Board of directors and SSB members**	30	30	30	5	16.7 %
• **Other banking departments**	100	100	100	63	63.0 %
Total internal users	130	130	130	68	52.3 %
Category 2: External users					
• **Government representative**	30	30	30	9	30.0 %
• **Stock market dealers**	25	25	25	12	48.0 %
• **Academic & researchers**	35	35	35	9	25.6 %
• **External auditors**	40	40	40	10	25.0 %
• **Shareholders**	20	20	20	6	30.0 %
Total external users	150	150	150	46	30.7 %
Total: internal and external	280	280	280	114	40.7 %

From the table it can be seen that the main returned questionnaires are from the internal users, 68 out of 130 distributed questionnaires have been collected which represents more than 52% while 46 returned questionnaires have been collected from external uses which represents 30.7%. The study achieved more than 40 % response rate in total.

5.6 Scale or level of measurement

Many statisticians have divided the level of measurement scales into four categories: Nominal or Categorical, Ordinal, Interval, and Ratio Scales. The weakest level of measurement is the nominal or categorical scale, which uses numbers to classify an object, person or characteristic into different mutually exclusive categories. In this study, there is a restricted use of this measurement in some questions contained within the questionnaire. For example, Q5, 1= have idea about AAOIFI, while 2= have not. Since any set of symbols may equally well represent the classification, the symbol can be changed if done consistently without altering the information in the scale. This means that the only kind of statistics admissible is descriptive statistics which would be unchanged by such transformation. However, in some cases, non-parametric tests such as X chi-square can be used to test such questions relating to distribution. Mathematical operations such as additions cannot be performed as it would be meaningless.

The ordinal or ranking scale is the next level of measurement. In this scale, objects in one category of the scale are not only different from other categories, but have some kind of relation, such as magnitude or order among them. The categories are related by a "more than" or "less than" scale. The choice of categories, however, and their position on the scale is not measurable. For example, in the Likert scale "strongly agree", which is given a scale of 5, does not twice the agreement of the scale marked 4. The science is not exact (Siegel 1998). By using an ordinal scale, objectives can be tested by a large group of non-parametric or distribution-free tests. For these non-parametric tests, the population is assumed to have conforming degrees of value.

The interval scale has its own internal ordering and the difference between any two numbers on the scale has meaning. This scale has no absolute zero. In this scale, the ratio of any two intervals is independent of the unit used and zero point. An example of an interval scale is temperature be it Celsius or Fahrenheit. It can be shown that the differences between reading one scale is equal to the ratio of the equivalent differences on the other scale. In the case of temperature the ratio between 30 and 10, and 10 and 0 degree Celsius is the same as the ratio between the equivalent 86 and 50, and 50 and 32 degree Fahrenheit. However, this scale is not affected by multiplying by a positive constant and adding a constant to this product. Since this is a truly quantitative scale, the entire common parametric statistic such as means and standards deviations can be applied for data measured on this scale. If data meets two further conditions i.e. normally distributed population and if the observations are independent then the researcher can utilise normal parametric tests such as *t test* and *F test.* Using non-parametric tests in such cases would not utilise all the information contained in the data set.

The ratio scale has all the characteristics of the interval scale, but in addition, has an absolute zero, for example, age and mass. The numbers used in this scale are the true numbers with a true zero. The ratio between any two numbers is preserved when multiplied by any positive constant and such transformation does not alter the information contained in the scale. Any parametric test can be used when this scale is achieved but it is rare in social science. Furthermore, Bryman et al (1997) argues that although the 1 to 5 the Likert Scale (as it is used in this study) is strictly speaking an ordinal scale, many researchers treat them as an interval scale. Thus, there seems to be a trend in the direction of this more liberal treatment of multiple-item scale as having the qualities of interval variables although many purists would demur from this position. Moreover, it does not appear to be a guiding principle which allows the analyst to specify when a variable is definitely ordinal and when interval.

Labovitz (1970) argues for the treatment of ordinal data as well as interval in view of the considerable advantages that can accrue to the researcher as a result of using analytical techniques such as correlation and regression which are both powerful and easy to interpret. In addition, he states that the amount of error that may occur is minimal. Bryman *et al* (1997) furthermore, argues that this process of treating ordinal data as interval becomes more compelling when the number of categories is considerably greater. Further, Sekaran (1992) states that the research already undertaken indicates that a slight increase in the number of items in a multiple-item scale does not improve the reliability of the rating.

Bryman *et al* (1997) defines the measurement as the attribution of numbers to the units of analysis which represent the concept or phenomena that the researcher is trying to discern. Measurement assists in the specification differences in the level of the concept found by allowing systematic differences between the objects to be studied.

In the study's questionnaire, four main concepts are measured as follows: the perception of the existence of AAOIFI as an independent organisation; the awareness of the applicable standards in preparing financial statements of Islamic banks operating in Bahrain; the usefulness of AAOIFI standards in preparing financial statements and the adequacy of information contained within the annual report of Islamic banks in decision making. In addition, there are some sub concepts, for example, the characteristic of financial information contained within the annual reports, the most important items contained within the annual reports, and the degree of satisfaction about the information published in the annual reports. To measure these concepts, statistical data analysis should be undertaken to manipulate respondents and various indicators are used in a separate group.

In this study, concepts like perception of usefulness of annual reports by users in decision making after applying AAOIFI standards usually needs several indicators to reflect the concept fully as there are usually many facets through which a concept might be expressed. A single indicator may leave out these other dimensions that together measure the concept. Therefore, it is proposed to apply two types of statistical data analysis to treat multiple-item measures such as those used in the questionnaire detailed on the interval scale. Thus the Likert scale (1 to 5) is used in this research as the main classification instrument, and the ranking scale and categorical scale are secondary. These are treated by using the interval scale to allow the researcher to perform non-parametric statistics.

5.7 Types of statistical data analysis

5.7.1 Descriptive statistic

Since the study investigates the users' perception about the usefulness of financial statements of Islamic banks that are prepared using AAOIFI standards in the state of Bahrain, it is appropriate to analyse the respondents' return in terms of difference behaviour of different users. According to Hofstede (1980) for further processing of the information contained in the frequency distributions, it is often necessary to reduce the information to a single number per frequency distribution. This can be done by dichotomising or by using a measure of central tendency. Following this direction, in the analysis of the data, the median as a measure of central tendency for the questions with ordinal scale will be used. In the case of questions with different scales, the frequency distributions at the most meaningful point will be dichotomised.

The median value that underscores the respondents' behaviour with respect to the stated research question is calculated on the basis of the lowest point and the highest point on the Likert scale. The study also ranked respondents' median responses to a question or an issue. For example, a response with a median score of 4 is ranked lower than a response with a median score of 5. The ranking order is especially important for the study which indicates the perception of the participant toward specific elements of accounting information contained within the financial statements of Islamic banks.

5.7.2 Statistical tests

Wilcoxon Mann-Whitney test

The Mann-Whitney test and the related Wilcoxon test are non-parametric alternatives to the independent-sample *t* test. Mann-Whitney tests the null hypothesis that two independent samples come from the same population. Rather than being based on a parametric of a normal distribution like mean and variance, the Wilcoxon statistic (W) is calculated by ranking the pooled observations of the two samples and obtaining the sum of the ranks of the population with the smaller sample size. The Mann-Whitney statistic (U) which is equivalent to the Wilcoxon statistic is obtained by counting the number of items and observations from the Wilcoxon statistic. This is obtained by counting the number of times an observation from the group with the smaller sample size precedes an observation from the larger group. The equation for the Mann-Whitney U is (SPSS Base10.0):

$$U = N_1 N_2 + \frac{N_1(N_1+1)}{2} - T_1$$

Where;

N_1, N_2	Are the sample size of the two groups
T_1	The sum of the ranks of one of the sample.

The Mann-Whitney U and the Wilcoxon W are related by the equation:

$$U + W = \frac{m(m+2n+1)}{2}$$

Where;

m	The number of observations in the smaller group
n	The number of observations in the larger group

In this study, the Mann-Whitney test is used to evaluate differences between population distributions not the differences between population medians. With the test therefore it is possible to obtain significant differences between groups when the median is, in fact, identical.

5.8 Summary

This chapter outlined the research methodology adopted in this study. The chapter investigated whether the implementing of the AAOIFI's standards in preparing the financial statements of Islamic banks is sufficient to provide users of such statements with the information they need. In addition, it stated whether the annual reports of Islamic banks contained any additional information and examined the usefulness of such additional information to the users in decision-making. To fulfil that, two methods are conducted in this study. Such methods have been used in similar studies (the content analysis and questionnaire method). The advantages and disadvantages of each method were discussed and the justification for choosing Islamic banks operating in Bahrain was presented. The methods are used to explore whether the recent annual reports of Islamic banks have been prepared adequately in accordance to the AAOIFI standards and fulfil the AAOIFI's requirements in particular; and state whether the recent financial information in the financial statements of the Islamic banks is more relevant, more reliable, contains sufficient disclosure and enables comparison.

Chapter Six

Data analysis

6 Introduction

The previous chapter discussed methods used in analysing data collected from different sources. This chapter is dedicated to analysing this data to achieve the study objectives and answer the study questions. Dunk (1995) states that a good annual report can be an effective communication vehicle to inform internal and external users, besides being a corporate marketing tool. The importance of uniformity in accounting measurement methods and reporting stems from the fact that the annual reports produced by the Islamic bank must be comparable and easily understood by users. This chapter aims to survey and examine the users' attitude towards the usefulness of financial information contained in the annual reports in decision-making by using a questionnaire survey. Content analysis, descriptive and statistical analysis of the data collected is included.

This chapter consists of three main parts: the first part starts by identifying the research problem and the research questions to be developed. Part two discusses the research design, validity and reliability, and sample error. Part three is the main part of this chapter which discusses the data analysis of the content analysis and its usage as the basis of the questionnaire stage. This is followed by analysing the data collected by using questionnaires. This part presents some descriptive statistics on the independent variables while the results of Kruskal -Wallis and Man -Whitney tests of significance are presented in the same section. This chapter answers the study questions and achieves the objectives. The chapter concludes with a summary of the main findings.

6.1 Identification of the research problem

The establishment of Islamic banks with their stated Islamic objectives reinforces the need for Islamic accounting. Adopting or even modifying conventional accounting concepts is insufficient to develop an accounting system which provides information leading to behaviour consistent with Islamic norms and Islamic objectives (Hameed, 2002). In this respect, the need for Islamic accounting standards for Islamic banks was felt in the early 1980s after the establishment of the first Islamic bank. The emergence of the "Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI)" in Bahrain on 27 March 1991 was the result of several meetings between pioneers in Islamic banks held to find out and examine the appropriate methods of preparing accounting standards for Islamic financial institutions.

However, there are several issues pertaining to accounting matters with reference to Islamic banks; for example, Idris (1996) discusses who should regulate accounting information. He expected the newly formed AAOIFI to successfully achieve reliability, comparability, uniformity, and consistency in accounting information for Islamic financial institutions because all the standards that issued by the AAOIFI were based on Sharia'h law. Several attempts have been made to realise these objectives; Pomeranz (1997) calls for specific accounting standards that fulfilled the objectives of Islamic financial organisations; Al- Hajji (1999) investigates the accounting treatment of the *Ijara* contract by Islamic banks in the GCC countries as a standard issued by AAOIFI.

This study is an attempt to explore the role of AAOIFI accounting standards in developing the Islamic accounting standards and encouraging Islamic banks to implement these standards to achieve their objectives in the society in which they operate. Bahrain was chosen for the purpose of the study, because this country hosts the organisation that issues and supervises the Islamic accounting standards and their application. Also, Bahrain is regarded as the lead country for Islamic banking in GCC countries, and it provides an attractive base for the Islamic banking industry. Moreover, the initial implementation of the AAOIFI standards starts in Bahrain and became compulsory for the Islamic banks operating there from 1999. Due to the sensitivity of the subject, two types of research methods are used in order to investigate and meet the study objectives.

6.2 Research questions

In order to fulfil the research objectives, a series of questions were formulated to address the principle issues.

6.2.1 The awareness of Islamic banks

- **Research question**: For how long have users of the financial reports of Islamic banks known and dealt with Islamic banks?

Banking started in Bahrain in the early 20th century when a branch of the Eastern Bank (now Standard Chartered Bank) opened in 1921. The birth of Islamic banking services in Bahrain dates back to 1978, as already indicated when Bahrain Islamic Bank was established to provide commercial banking services.

Islamic banking in Bahrain gained momentum in the early 1980s. As of mid-2004, the total number of Islamic banks operating in Bahrain reached 26, of which four are full commercial banks, three are offshore banking units, and sixteen are investment banks, with the remainder being a representative office, an investment advisor and an Islamic infrastructure fund (BMA 2004).

Due to the age of banking in the state in general and of Islamic banking in particular, this question involves investigating the awareness among the clients of Islamic banks in the state of Bahrain.

6.2.2 Organisations involved in setting accounting regulations.

- **Research question:** Who should regulate Islamic accounting information and who should represent the process of accounting?

Accounting is often referred to as the language of business; hence differing accounting and auditing standards may affect the decision of resource providers to the extent that they fail to understand or trust the messages conveyed by financial information (Idris, 1996). The debate about who should formulate accounting principles, the public or the private sector, has continued for many years. Some opinions state that standard-setting should be left to the private sector because it seems that the FASB (in the USA) has had success in responding to various constituents and has proved itself as having the necessary technical knowledge to develop and implement suitable measurement and disclosure systems. The

Accounting Standard Board (ASB) in the UK is regarded as possessing similar qualities.

However, there are also those who support the public sector as a regulatory body because the power it has enables it to protect the interests of investors against information abuse. Pomeranz (1997) claims that the central bank or other local authorities, which grant operating licenses to Islamic banks may influence operations to some extent. In Kuwait, the influence of the central bank is relatively slight, because the Islamic bank's articles of association (statutes) and its special status have been approved by the cabinet. In Saudi Arabia, the operations of Islamic banks are affected by the Saudi Arabian Monetary Authority (SAMA).

On the other hand, there are those who are totally against regulation by the public sector or private sector separately and they claim that both private and public sectors should co-operate to regulate accounting information. In the UK and the USA a mixture of public and private sector regulation appears to work very well. Some claim that the private sector has to be watched and guided and though it may be granted the authority to formulate accounting standards, a watchdog of some sort is deemed essential (Belkaoui, 1993).

In most Islamic nations (especially in Iran, Pakistan, and the Sudan), Islamic banking is influenced by national goals. Bahrain is the heart of the Islamic banking industry in GCC countries, and the Bahrain Monetary Agency (BMA) recognises the importance of this industry to the region and is fully committed to the growth and the development of the industry. At the same time, the BMA has the responsibility to ensure that Islamic banks are adequately regulated and supervised. This will act to maintain and enhance the confidence of the participant in the financial services industry, in their dealing with Islamic banks.

In recognition of this problem, several international and regional organisations are attempting to harmonise accounting and auditing standards (Mueller *et al*, 1991). It is the aim of AAOIFI to set accounting standards for Islamic banks and other financial institutions, in order to maintain the trust and confidence of their investors. The above research question aims to find out who should be responsible for the regulation of accounting standards for Islamic banks in particular.

6.2.3 Applicable accounting standards in Islamic banks

- **Research question:** Which type of accounting standards are Islamic banks following?

Accounting should provide the base for evaluating the effectiveness of the use of resources. Therefore, the use of suitable accounting standards, which fit the main purpose of items, will produce useful information that has a positive impact in decision-making. Thus the information that the accounting provides must be reliable and factual. One of the main points which can be extracted from the literature review is: that the cultural, social, economic, and political are factors which have considerable effects on the kind of financial statements to be provided. Therefore, it is necessary for Islamic banks to look for suitable accounting standards that can emerge from their own culture (*Sharia'h* law) to fulfil their objectives such as purifying a Muslims' funds from the sin of usury and other prohibited transactions, and to obtain their customers' trust and their satisfaction with its operations.

However, because Bahrain is a member of IASC, most of Bahrain's Islamic banks implemented IAS accounting standards before implementing AAOIFI standards. Accordingly, it was decided that the research question above could explore the users' perceptions of the accounting standards adopted by most Islamic banks operating in the state of Bahrain at present.

6.2.4 Suitable accounting standards for financial statements of Islamic banks

- **Research question:** Which types of accounting standards are most suitable for Islamic banking?

The emergence of Islamic banks in the Middle East and other parts of the world over the last three decades has brought forward the issue of their relationship with the regulatory authority, in particular with accounting regulatory bodies. Most Islamic banks adopt accounting standards from local accounting authorities or from those of the IASC in preparing their annual reports.

Collett (1995) argues that accounting standards can affect the behaviour of the intended recipients of financial reports. They can also affect the behaviour of managers of reporting entities. For example, managers may change their investment strategies in anticipation of an unfavourable reaction to information that will have to be supplied to comply with a new standard. Collett (1995), also states that the financial reports on which they are based, contribute to the efficiency of resource allocation and to the distribution of wealth within an economy. Therefore, it was decided that the research question above provides useful information about suitable accounting standards that have been implemented by Islamic banks

6.2.5 The awareness of AAOIFI

- **Research question:** Do the users of financial reports of Islamic banks (Internal and external) know about the existence of AAOIFI?

In the 1970s, Muslims were seeking a model for the establishment of Islamic banking services. With rapid development, Islamic banks are currently faced with accounting problems relating to uniformity in financial reporting and the standardisation of accounting measurements. For example, the issue of the exposition and disclosure of the *Ijara Muntahia Bittamleek* is still being debated. A study conducted by Al-Hajji (1999) supported by a field survey by AAOIFI explores the variations of treating the contract for example; some banks depend on IAS No. 17 (Accounting for Lease) with some modifications. However, this standard is based on the concept of capitalisation of the leased assets which runs counter to provisions of the *Sharia'h. Ijara Muntahia Bittamleek* is however regarded as two separate contracts; first, an *Ijara* contract with a promise to grant the asset to the lessee after the payment of all rental instalments; second, an *Ijara* contract promises to sell the asset to the lessee in exchange for a nominal or actual price, which the lessee pays at the end of *Ijara* period after paying all the rental instalments agreed upon. The foresaid survey reveals differences among the Islamic banks in the measurement of leased assets and the disclosure in financial statements. Such matters are of great importance, particularly when seen against a background of competition with the well-established western traditional banks and in the hope of gaining confidence of investors in the capital market.

Thus, the financial reports of Islamic banks should be perceived as useful to users and provide a realistic picture of the position of the business enterprise in clear and readable format. In order to achieve this, a uniform accounting system is seen as essential for Islamic banks, and this will enhance the quality of the information available to users. Hence 1990 witnessed the creation of the AAOIFI commissioned to set standards for all Islamic banks and financial institutions. In October 1993, this organisation approved its first set of standard rules which were to be implemented in all Islamic banks by January 1996.

To gain the trust and confidence of all Islamic banks, AAOIFI must publicise itself through seminars in Muslim countries in Islamic banks and by establishing its own training programmes; thus it is felt important that the above research question addresses the issue of awareness amongst the Islamic bankers and customers under examination.

6.2.6 Useful items contained the annual reports of Islamic banks

- **Research question:** Which items are the most useful and commonly used when decision-making?

Items reported in any annual report are intended to provide information to various users who make decisions relating to profitability and liquidity of the organisation. According to Cook and Sutton (1995), shareholders are not all from the same background; hence they read published financial statements in different ways and have very different information needs. Some writers state that traditionally the balance sheet and the profit and loss account are the most commonly used by investors in the investment decision-making process (Epstein and Anderson, 1994; Berry and Waring, 1995). The statement of cash flow becomes more important, while the income statement regarded as less significant (Epstein and Pava, 1993).

However, Taheri (2002) states that from an Islamic perspective the primary focus is on the balance sheet because Islamic banks are based on the macroeconomic model as the main source of information, while the British-American model focus on the income statement, because this model is based on the microeconomic model. The Islamic viewpoints numbers items in addition to the conventional items contained in the annual report and these include: SSB report, *Zakat* statement, and *Alqard Alhassan* statement. For this reason, the research question is attempting to examine which specific items in the Islamic bank's annual reports are being read and perceived as useful by internal and external users.

6.2.7 Enhancement and improvement of the annual reports

- **Research question:** What items should be included in the annual report to enhance and improve the usefulness of financial information in decision-making?

The annual report is a credible database when it has to comply with regulatory needs. It reflects the integrity of management in communicating objectively and comprehensively, importantly, its content will have undergone due audit process. The responsibility rests on those who prepare annual reports to ensure that investment-influencing information meets the needs of those for whom such communications are intended (Courtis, 1995). Therefore, the preparers of annual reports must pay attention to meet the users' information requirements.

Previous studies show that the income statement, balance sheet, earning per share and statement of change in owner equity are respectively the most important items (Idris, 1996). Some previous studies indicated that most shareholders believe that summary annual reports are easier to read because they use a limited amount of technical language and are easier to follow (Cook and Sutton, 1995).

The annual report is regarded as one of the major pieces of information presented by an organisation; therefore, the company's management must exert their efforts to present suitable information so that the intended message is communicated to the end users (Neimark, 1992). This has important implications for the design and content of the annual report. As mentioned in chapter 5, AAOIFI illustrates in its first accounting standard the main items that should be included in the annual report. It is vital therefore to ensure that the most useful items are contained within the annual financial reports for its users.

6.2.8 Additional information

- **Research question:** Is there any additional information disclosed in the financial statements after applying AAOIFI accounting standards?

Islamic banks should be based on the principles of *Sharia'h* law which is guided by the *Holy Qur'an* and the *Sunnah* (see glossary) as its primary sources of reference. Every Islamic bank is required to have its own *Sharia'h* Supervisory Board (SSB) composed of Islamic scholars. The function of SSB members is to monitor the bank's activities, so that it does not violate *Sharia'h* principles. Trading in alcohol, being involved in gambling or transacting business based on interest are all violation of *Sharia'h.* However, Epstein and Anderson (1994) argue that companies need to revise their attitudes because the need for additional disclosure is strong. This finding also supports the desire to disclose additional information in future. Previous studies show that institutional investors want additional disclosure of financial information to assist them in determining whether to buy, hold, or to sell shares (Chang and Most 1985, Epstein and Pava 1993 and Idris 1996).

In addition to the AAOIFI structure, the SSB ensures that the practices and activities of Islamic banks do not contradict with Islamic ethical standards. As mentioned in chapter four, the powers of the SSB among others are: achieving harmonisation and convergence in the concepts and applications to avoid any contradiction which could exist; assessing the development of the approved *Sharia'h* instrument; and examining any inquiries referred to the SSB from Islamic banks. Also, the AAOIFI standards provide additional information by publishing additional statements such as the *Zakat* statement, the *Alqard Alhassan* statement, and additional information about social contributions. Such information is required by the Islamic bank to ensure *Sharia'h* requirements are carried out.

An additional study objective is to reveal whether applying AAOIFI standards adds more disclosure about the published information in the annual reports of Islamic banks.

6.2.9 Motivation factors

- **Research question:** What are the most important factors motivate individuals to deal with Islamic banks?

The bank industry today is moving toward the goal of integrated financial services because of strong competition and rapid changes in technology. Islamic banks take heed and start thinking strategically by providing high quality information and services to satisfy their customers. Pomeranz (1997) states that the need for Islamic banking is derived from three considerations: 1) an Islamic investor should avoid association with industries prohibited to Muslims such as alcohol, gambling, pornography, pork meat, weapons production; 2) an Islamic enterprise should avoid interest (*riba*), along with gambling, and, accordingly, restrictions exist on trading in debt securities and in futures and options; 3) many Muslim investors tend to be attracted to enterprises observing Islamic ethical and moral standards.

In addition, Yaquby (2001) stresses that any organisation which wishes to act as an Islamic bank should have the following features: a) complete segregation of funds; b) the existence of a *Sharia'h* Supervisory board (SSB); c) a management committed to Islamic financial concepts; d) a safeguard for investors funds from negligence, trespass, and fraud; and finally e) compliance with the standards of the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI).

Some writers view that the main factor enticing customers to deal with any kind of organisation is the quality of product or service. Indeed customers expect service quality (Bitner, 1990; Cronin and Taylor, 1992). Idris (1996) states that the most important factor attracting customers to Islamic banks is the inclusion of the word "Islamic" in the bank's name. Another study conducted by Nasser et al

(1999) in Jordan revealed that 84 per cent of the respondents strongly agreed with their respective Islamic bank's name and image. It is necessary to explore this issue further in order to discover the precise reason why customer numbers are increasing.

6.3 Research design

As stated previously, research is mainly exploratory in nature and seeks to explore the impact of the AAOIFI standards on the financial reports of Islamic banks amongst those who are using these financial reports in decision-making. It is concerned to understand the majority opinion or perception toward the alternative applied standards in preparing financial statements of such banks. Accordingly the study intends to start by using content analysis for the published annual reports of Islamic banks to find out the lack or shortfall in applying alternative standards. To reach such objective, a comparison between two annual reports prepared in accordance with different standards has taken place in this study (as explained in chapter five). This step is followed by a questionnaire which aims to examine, in part, the shortfall in applying AAOIFI standards which will be revealed in the content analysis. The extent to which the impact of applying alternative accounting standards affects users' perceptions of financial statements is sought.

Descriptive analysis relying on percentage and median took place at the first stage of the questionnaire analysis. Variations between respondents were analysed by using statistical instruments. The Kruskal Wallis and Mann-Witney scale are used in this respect. Further, a comparison between internal users and external users is considered in this chapter. The aim of this comparison is to examine the perception of each group separately and to compare them with the users as a whole.

6.4 Validity and reliability

Whenever measurement takes place, there is always the possibility of errors. These errors could be procedural errors, namely an improper undertaking of the study or there might be problems with the measuring instrument itself. In order for the research to be accepted by the academic community, the validity and reliability of the research results must be demonstrated as far as possible. When the measurement error occurs randomly between cases (in some cases positive and some cases negative), then the observed median score is an unbiased estimate of the true result despite the measurement errors (Summers 1977).

However, if the same measure is given repeatedly to the same person, it may produce a different set of scores. This is said to affect the reliability of the measurement. Hence, reliability of a measuring instrument refers to the consistency of the scores produced on repeated measurement. Therefore, the presence of random errors affects the reliability or consistency of the measuring instrument. Accordingly, errors need not be random. If an observed score is systematically affected by other variables to which the instrument is not sensitive, it is said to affect the validity of the measurement procedure. Hence, measurement of validity of an instrument measures both random and constant errors whereas reliability measurements only measure random errors.

6.4.1 Validity

It is commonly stated that the measurement scale is valid if it measures what it sets out to measure (Moore 1995). Since a questionnaire is designed to elicit information from respondents, one of the criteria for the quality of a question is the degree to which it elicits the information that the researcher seeks. This criterion is called validity (Sudman and Bradburn 1983). Therefore, validity is a very important characteristic of an instrument or procedure produced to measure exactly what it is designed for. However, the quality of the conclusion of empirical research is heavily dependent on the quality of data collected for such research (Huck and Cormier 1996).

Sekaran (1992) states that the content validity provides instruments of measurement which should include an adequate and representative set of measurements that would realise the concept. In other words, content validity measures how the dimensions and elements of a concept have been delineated. Sekaran (1992) also suggests that the face validity is a minimum index of content validity, i.e. whether the items look like measuring what they are supposed to measure. Measuring face validity is a subjective procedure wherein experts give their judgements on whether the items are valid. As mentioned earlier in chapter five, the questionnaire went through several revisions and a pilot study. Postgraduate students in different universities in the UK especially those who are in the same department were consulted in the process of designing the questionnaire. As a result, the validity of the questionnaire was judged to be adequate.

6.4.2 Reliability

Reliability refers to the consistency of the test to produce the same results on repeated use. Otherwise the measuring instrument would not be accurate over repeated use. Reliability can be divided into external and internal reliability. External reliability refers to the consistency of the measure over time. To test such reliability; the same test could be administered twice to the same group of participants after some time lapse. This was not an option in this research. Hence, external reliability could not be tested. However, internal reliability of the items in the questionnaire was tested using SPSS alpha model. This test gives us an idea of how reliable a group of questions measure the same concept when they are added together to get an index or aggregate score, as is undertaken in this study. On the other hand, since there are many ways in which we can split the items in a scale, there may be different measures of reliability depending on how we split the items of the scale. To get over this, Cronbach's Alpha which generally measures the average of all possible split-half reliability coefficients is calculated. If alpha measure results in is 0.8 or above (as a guiding principle), then the items are said to be internally reliable (Bryman and Cramer 1997).

6.4.3 Sample error

In order to generalise findings to the populations, the characteristics of the sample must represent the characteristic of the population. In this research, the respondents for the questionnaires, as discussed earlier, were from internal users and external users. 130 questionnaires were distributed to the internal users (banks' board of directors and SSB members, other banks' department employees). Another 150 questionnaires were hand delivered to the external users; this group comprised government representatives, clients of Islamic banks, stock market dealers, external auditor agencies, shareholders, academics and researchers. Of these, 114 questionnaires were returned representing a response rate of about 41%. Of those responding, 52.3% were internal users, while 30.7% were collected from distributed questionnaires among the external group. In addition, some of the questionnaires were partly completed. Most were however usable for many of the questions. The sample size of each question therefore varies up to a maximum of 113. Missing values are taken into account when computing aggregate scores. It can be seen that the highest respondent ratio is the other bankers department at 63.0%; meanwhile the lowest respondent ratio is the Board of directors and SSB members at 16.7%.

From the above percentages, it can be seen that the sample is acceptable because the average percentage is over 40%. However, the external users are comprised as a collected ratio from this group, 30.7%. While the internal users comprised over 52.3% of the response is from the distributed questionnaire among this group.

6.5 Data analysis

6.5.1 Analysing the content of annual reports

This part of data analysis is an attempt to answer questions 1 and 2 from the research questions. It should be remembered that some questions in the questionnaire investigate only a part of the findings of the content analysis. This part treats the lack or shortfall explored from implementing AAOIFI standards in preparing items contained within annual reports of Islamic banks. Therefore, a comparison between annual reports, 1997 and 2002, demonstrates the application degree of AAOIFI standards. Table 6.1 shows clearly the existence of implementing AAOIFI standards in published annual reports of Islamic banks in 2002. Nevertheless, the degree of implementation of such standards varies from bank to bank. These implementations and variations have been demonstrated in the following points:

Table 6.1: content analysis of annual reports of Islamic banks (1997 & 2002)

Area	Item to be disclosed	Bank annual report 1997				Bank annual report 2002			
		A	B	C	D	A	B	C	D
Part one: Background information	The existence of SSB.	×	√	√	×	√	√	√	√
	Offering traditional banking products.	√	√	×	√	×	×	×	×
	The banks have more than 10 years experience.	√	√	√	√	√	√	√	√
	The banks were operating in different areas.	√	√	√	√	√	√	√	√
	The banks were established as Islamic banks.	×	√	√	√	×	√	√	√
Part two: Auditor report	Reports are addressed.	√	√	√	√	√	√	√	√
	Referring to auditor standards followed.	×	√	×	×	√	√	√	×
	Referring to the accounting standards applied.	√	×	×	×	√	√	√	×
	Reports are signed and dated.	√	√	×	×	√	√	×	×
	The report contains the main requirements.	√	×	×	×	√	√	√	√
Part three: Sharia'h Supervisory report	Existence of the reports.	×	√	×	×	√	√	√	√
	Referring to the scope of the report.	×	×	×	×	×	×	×	√
	Referring to the accounting standards used.	×	×	×	×	√	√	√	×
	The reports are signed and dated.	×	×	√	√	√	√	√	√
	The reports raised issues about activities.	×	√	×	×	√	√	√	√
	Declaring the prohibited transactions.	×	×	×	×	√	√	√	√
	Referring to the disposal of non-Islamic income.	×	×	×	×	√	√	√	√
Part four: Accounting policy	Referring to the accounting standards used.	√	√	√	√	√	√	√	√
	Applying AAOIFI standards.	×	×	×	×	√	√	√	√
	Publishing a separate retained earning statement.	√	√	×	×	√	√	×	×
	Using fair value method.	×	×	×	×	√	√	√	×
	Publishing Zakat and Charity statement.	×	√	×	×	×	√	√	×
	Calculating reserves and provisions for impairment assets.	×	×	×	×	√	√	√	√

	Applying Zakat standards.	×	×	×	×	√	√	×	×
	Referring to the basic profit and loss allocation.	×	×	×	×	√	√	√	√
	All non-Islamic income credited to charity funds.	×	×	×	×	√	√	√	√
	Referring to social responsibility.	×	×	×	×	√	√	√	√
Part five: Focusing on Islamic activities	The banks produce additional traditional services.	×	×	×	×	×	×	×	×
	The banks finance only Islamic services.	×	×	×	×	√	√	√	√
	The banks prohibit non-Islamic services.	×	√	×	×	√	√	√	√
	Share profit with the investment account holders.	×	√	×	×	√	√	√	√
	Non-Islamic income transferred to social contributions.	×	×	×	×	√	√	√	√

A= ABC Islamic Bank, B= Bahrain Islamic bank, C= Al Baraka Islamic Bank, D= First Islamic Bank.

√= Yes, x= NO

Part one: Background information

This part of the analysis contains general background about the Islamic banks such as whether these banks are established as Islamic banks and the experience of Islamic banks in offering Islamic financial products. In more detail, part one in table 6.1 covers the following points:

- The analysis shows that 2 out of 4 sample Islamic banks have *Sharia'h* Supervisory Board in 1997 under different names. However, this supervision board exists in all Islamic banks according to their annual reports in 2002.
- The annual reports in 1997 reveal that 3 banks in the sample offer and present conventional financial products and services beside Islamic services. Meanwhile all the banks in the sample restrict their operations on Islamic productions and services in 2002 to comply with *Sharia'h* law.
- ABC Islamic bank is a unique bank converted from operating as a traditional bank to a bank offering Islamic products. Other banks meanwhile were established as Islamic banks.

Part two: The audit report

The purpose behind issuing the audit report is to provide a clear written expression and an independent opinion on the financial statements. This report should contain the basic elements which are; title, address, opening or conducting paragraph, scope paragraph [reference to the relevant accounting standards] description of the work the auditor performed, opinion paragraph, auditor address, and the auditor's signature (AAOIFI, 2002). Table 6.1 exhibits the main points that have been investigated in the auditor report as following:

- The analysis reveals that the auditors addressed their reports to the shareholders in all sample banks in both years 1997 and 2002.

- The analysis shows that some of the auditor reports refer to the auditing standards used in conducting audit performance. Accordingly, one Islamic bank in 1997 indicates the standards followed in its auditor's report as opposed to three Islamic banks which refer to the standards in 2002.

- In 1997, the analysis shows that two banks refer to the accounting standards applied, while three banks refer to them in 2002.

- The analysis shows that two auditor reports were not signed and dated in 1997. Meanwhile, in 2002, all reports were signed and dated.

In general, the published auditor reports did not differ to conventional reports except the Islamic banking auditor reports having regard to the requirements of appropriate Islamic rules and principles.

Part three: *Sharia'h* Supervisory Board (SSB) report

In order to ensure that the practices and activities of Islamic banks do not contradict the Islamic ethical standards, Islamic banks are expected to establish a

Sharia'h Supervisory Board, founded upon Muslim jurisprudence, which acts as an advisory body to the Islamic banks. AAOIFI emphasised that the annual report should contain SSB report and this report should contain; title, address, opening introductory paragraph, scope paragraph describing the nature of work performed, opinion paragraph, date of report and signature of the members of *Sharia'h* Supervisory Board (AAOIFI, 2002).

With regard to the above, Table 6.1 reveals the following points:

- The content analysis shows that the SSB reports existed before implementing AAOIFI standards. Bahrain Islamic Bank has enclosed its annual reports in 1997 by SSB report. The AAOIFI have just re-regulated and formulated the SSB report. However, as a required report, all of the samples of annual reports include SSB reports in 2002 annual reports.

- As a part of the report requirement, the analysis reveals that the published SSB report in 1997 did not refer to the scope of the work. This is probably due to the absence of an existing model of a uniform statement that can be followed in such circumstances. The lack of experience and expertise in preparing such reports may have existed as well. In 2002, there is more understanding about the requirements of the report (all the reports refer to the scope of the reports).

- According to the accounting standards implemented, none of the SSB reports mention the accounting standards applied in the 1997 annual reports. The 2002 SSB reports show that the First Islamic Bank is the sole bank which refers to the AAOIFI accounting standards. The other three banks did not specify the type of the accounting standards used in their SSB reports. Therefore, it can be seen that the preparation of the SSB reports is merely a replication of the previous reports.

- Similarly with the auditor reports, the analysis shows that only Bahrain Islamic Bank signed and dated its SSB report in 1997. By 2002 all SSB reports were signed and dated.

- SSB reports raised certain issues about the banks' activities. One of these issues is revealed in the 1997 annual report (Bahrain Islamic Bank). The department of *fatwa* and research has examined and corrected the files and reports of investment operations in which there were problems with their legality. This did not happen in the other banks. However, all SSB reports raise issues related to the banks' activities in 2002. For instance, referring to the disposal of non-Islamic incomes.

- Before implementing AAOIFI standards (in 1997), It was found throughout the analysis that the entire sample did not report banned incomes in 1997. For example, ABC Islamic Bank in Bahrain acts as a conventional bank besides its Islamic financial dealings. The traditional activity would have included non-Islamic returns and such returns are considered as non-prohibited income by law. This may prevent the bank declaring how such returns are disposed of. However, the analysis shows that all banks announce that non-Islamic incomes were credited charity funds.

Part four: The accounting policy

The disclosure ratio and the result of the content analysis in Table 6.1 shows clearly that the extent of enforcing Accounting and Auditing Organisation for Islamic Financial Institutions standards by Islamic banks has a short of sufficient implementation. The following points are relevant:

- The content analysis reveals that the annual reports contained within the sample applied accounting standards in their accounting policy section in both years 1997 and 2002. All banks refer to the change that happened in their accounting standards, except one which was ABC Islamic bank which applied both International Accounting Standards (IAS) and Accounting and Auditing Organisation for Islamic Financial Institution (AAOIFI) standards in preparing its financial statements.

- Although, AAOIFI specified the statements that should be published by Islamic banks, the analysis reveals that some of the banks in the sample still did not fully comply in their 2002 annual reports. For example, Albaraka Islamic Bank and First Islamic Bank enclosed their retained earnings in their income statement and they also did not publish a *Zakat* statement in spite of declaring their responsibility for the calculation and distribution of *Zakat*. This finding is inconsistent with what Taheri argued for. He states that the cultural, social, economical, and political are factors that should have considerable effects on the kind of financial statements to be provided (Taheri, 2002).

- The analysis revealed that some of the samples had, to varying degrees, failed to fully apply the AAOIFI standards in 2002. For example, First Islamic Bank is still using the method of historical cost or market value whichever is lower, while others used the concept of fair value.

- It was found that only one bank published a *Zakat* statement in 1997 and two in 2002. The importance behind preparing a *Zakat* statement at the first stage is to expose the real value of assets and liabilities, as understating assets would mean less *Zakat* liabilities. Likewise, overstating liabilities would result in less *Zakat*. Paying *Zakat* is one of the most important religious duties of Muslims, and Islam encourages Muslims to be generous with their wealth. This differs with the concept of conservatism or prudence issued by Anglo-American accounting and differs, as well, to the valuation of inventories concept which is issued by GAAP. Anglo-American accounting standards would not therefore be appropriate for *Zakat* purposes.

- The analysis shows that in 1997, none of the samples published an *Alqard Alhassan* statement, but in 2002 there were two banks that did. The result of applying this standard meant that some of the banks in the sample weren't aware of AAOIFI requirements. Also reveals the shortfall of implementing AAOIFI standards

- The analysis reveals that the entire sample did not calculate reserves or provisions in 1997 on the impairment assets. unlike in 2002 when all banks calculated these kinds of reserves and provisions.

- With regard to whether the banks applied the *Zakat* standard, it was found that the First Islamic Bank did not provide disclosure about *Zakat* (as requested by AAOIFI). This result is consistent with a study conducted by Maali *et al* (2003). Regarding the calculation of *Zakat*, the analysis reveals a shortfall in the disclosure about this standard. For more explanation, the analysis reveals that there were two banks which published *Zakat* statements with full disclosure in 2002; another two banks discounted *Zakat* from their net profit. All the banks refer to the remaining balance within other liabilities in the balance sheet.

- Moreover, the analysis shows that in 1997 none of the sample banks refer to the basis of profit and loss allocation. At the same time, annual reports show that all banks refer to this issue in 2002. However, Islamic banks' annual reports in the sample did not declare the methods of distributing the profit between bank and investors, and unrestricted investment account holders.

- The analysis shows that none of the sample referred to the disposal of non-Islamic income in 1997, but in 2002, three out of four banks did.

- One of the most important objectives of Islamic banking relates to social contributions. The analysis shows that all Islamic banks specified their social contributions made in 2002, whereas not one had announced this in their 1997 annual reports. However, the disclosure in this respect is not enough because all banks did not revel how distribute the charities.

Part five: Islamic banking activities

This part of the analysis focuses on the banks' activities and the return from offering these financial products. The results from this part reveal that the banks have channelled their funds into products which fit with Islamic *Sharia'h* law. The results are as follows:

- The analysis shows that three out of four Islamic banks offered traditional products in 1997, while none of the banks declare that the offered such products in the 2002 annual reports. This means that before applying AAOIFI standards, Islamic banks are not fully compliance with *Sharia'h* law and this is may attributed to the absence of the *Sharia'h* Supervisory Board

- In the sample none of the Islamic banks declare any banned transactions made in 1997. However, all banks declare any prohibited products in 2002.

- The analysis shows that in 1997, the Bahrain Islamic Bank was the sole Islamic bank shares profit with the investment accounts holders. Meanwhile, all banks in the sample declare sharing their profits by restricted percentage in 2002.

- The 1997 annual reports indicate that none of the banks announce the disposal of prohibited income. At the same time, the entire sample declares that all non-Islamic income is transferred to social contribution.

6.6 Questionnaire analysis

Islamic banks currently face various types of competitive pressures from both the traditional commercial banks and other Islamic banks and Islamic investment companies. The scope of this competition has grown in recent years to include every market, product or service. In this highly competitive environment, especially Islamic banks as they are new and wish to expand their customers (cf. UK Islamic mortgage are expanding as Islamic banks grow in that country), need to build good relationships with their clients. This relationship is based on the reliability and credibility of information the users need in their decision-making when they deal with such banks. To fulfil such a requirement, Islamic banks should apply acceptable and suitable instruments in preparing their published information. Accounting and Auditing Organisation for Islamic Financial

Institutions (AAOIFI) was established to issue and promulgate accounting standards which are based on *Sharia'h* law and intend to play a crucial role in formulating financial information of Islamic banks and other financial institutions in accordance with the desire of Muslim people. The following, therefore, is an investigation to survey the perception of certain users of financial statements, their attitude toward applicable standards in preparing financial statements and their impressions about the usefulness of such financial statements in decision-making.

Part 1: Users profile

The success of investigating or examining the impact that resulted from applying alternative accounting standards in preparing financial statements depends on maintaining up-to-date and complete profile information about the users of such statements. This includes background information about respondents (internal and external users of financial reports). The following items were included in the questionnaire: age and education of participants, period of experience, expertise, their awareness of Islamic banks, their dealings with Islamic banks, and the nature of their relationship with Islamic banks. Such general information is considered useful in providing the respondents with an easy introduction to the questionnaire and in obtaining useful data on the background of respondents. This information is also important in building neutral opinions about the participants and their judgements about the investigated items in this subject. Table 6.2 presents a comprehensive profile of the users of financial statements of Islamic banks participating in this study.

Table 6.2: Background information on users of annual reports of Islamic banks

Items	Frequency N=114	Percentage (%)
Age of candidate		
◊ 25 years or less	1	0.9
◊ >25 – ≥35	53	46.5
◊ >35 – ≥45	32	28.1
◊ Over 45	28	24.5
Qualification		
◊ Intermediate or less	12	10.5
◊ Bachelor	65	57.0
◊ Masters	30	26.3
◊ Doctoral	7	6.1
Period of experience		
◊ one year or less	1	0.9
◊ >1 – ≥5	22	19.3
◊ >5 – ≥10	35	30.7
◊ More than 10 year	54	47.4
Missing cases	2	1.8
Expertise: Group I (internal)		
◊ Board of director & SSB members	5	4.4
◊ Bankers	63	55.3
Group II (External)		
◊ Shareholders	6	5.3
◊ Government representatives	9	7.9
◊ Stock market brokers	12	10.5
◊ Academics & researchers	9	7.9
◊ External auditors	10	8.8
Awareness of Islamic banks		
◊ One year or Less	2	1.8
◊ >1 – ≥5	16	14.0
◊ >5 – ≥10	33	28.9
◊ More than 10	54	47.4
Missing cases	9	7.9
Dealing with Islamic banks		
◊ One year or Less	6	5.3
◊ >1 – ≥5	32	28.1
◊ >5 – ≥10	22	19.3
◊ More than 10 years	40	35.1
Missing cases	14	12.3
Kind of relationship		
◊ Having current account	35	30.7
◊ Having saving account	19	16.7
◊ Having investment accounts	14	12.3
◊ Having shares	6	5.3
◊ Speculator	12	10.5
◊ External auditors	10	8.8
◊ Other	18	15.8

The results reported in Table 6.2 show that over 75% of participants are less than 45 years of age. This percentage appears to be in line with the findings of previous studies (Rondall 1993, Metawa And Almossawi 1998). Regarding to the age of Islamic banks in Bahrain (established in 1978), this age of the group is likely to have a far-reaching influence on the Islamic banks' financing schemes and consequently any information they publish. With regard to mature users, this group are over 45 years of age and represent over 24% of participants.

In addition, the results reported in the Table 6.2 show that the majority of the participants are well educated, with more than 89% holding bachelor degrees or above and less than 11% are educated to a standard of intermediate or less. This result is consistent with Metawa et al (1998). This ratio indicates that the preparers of financial statements are qualified (because they represent about 60% of the participants). This has an effect on the preparation of financial statements. The statement should consequently be easy to understand and should provide managers of Islamic banks and other users with valuable information for decision-making.

The results in Table 6.2 also show that the participants have significant experience; 78.1% have had a period of experience exceeding 5 years in their work. This percentage includes the preparers of financial statements of Islamic banks which should mean that these statements are prepared effectively. These results are in line with Al-Hajji (2003) who states that more than 77% of the Islamic bank staff has more than 5 years experience.

With regard to the expertise of the participants, this study gives considerable attention to this point. Table 6.2 shows two different groups. Firstly, the internal users of financial statements which include the preparers of such statements, including top management such as board of the directors & SSB members, middle management (bankers). About 60% of the sample comprised this group. Secondly, the external group which includes different types of users, such as shareholders, government representatives, external auditors of Islamic banks, academicians & researchers, etc. This group represents 40%. The aim behind this variation is to collect different views about the usefulness of financial statements after implementing AAOIFI standards and this will help to obtain the study objectives from the researcher's viewpoint.

The awareness of Islamic banks is a part of the profile of users in this study. From Table 6.2, it can be seen that more than 76% have had awareness of Islamic banks for more than 5 years and 14% fall in the range >1 to ≥5 years. Meanwhile, the rest have had awareness of Islamic banks for less than one year and there are some missing cases. The results serve to study users' neutral judgements on the usefulness of financial statements prepared according to AAOIFI standards in decision-making.

The previous results are confirmed by the next point which reveals that more than 54% have been dealing with Islamic banks for more than 5 years. Meanwhile, 28.1% fall in the range >1 to ≥5 years. The results reveal that the majority of participants were dealing with Islamic banks before applying AAOIFI standards (the compulsory implementing began in 1999). This enforces the judgement about the usefulness of such statements because those users might be aware of the different philosophies of the two accounting standards used in preparing such statements.

Finally, the results in the last part of Table 6.2 indicate the kind of relationship the participants have with the Islamic banks. This relationship varies from having different types of accounts, possessing shares, or having other relationships (for instance external auditors). Such close relationships give credibility to the assessment of information published in the annual reports of Islamic banks by surveying the participants' impressions about such annual reports.

Part Two, Section 1: The need for regulating accounting information and the question of its regulation.

The aim of this section is to investigate the perception of the users of financial information toward the need for regulating accounting information in way that serves their needs. This section aims to answer the study question No. 2. Hence, question 2 listed in Table 6.3 identifies the most important source of information which helps individuals when dealing with Islamic banks. Question 4 meanwhile investigates the sector that sponsors the regulation body. Question 3 in Table 6.4 asks participants about the need for regulating accounting information.

Table 6.3 (Section one): The need for regulating accounting information (Likert scale)

Question	Str. Agree %	Agree %	Indifferent %	Disagree %	Str. Disagree %	Missing %	median	Valid cases
2A: Annual reports	55.3	36.0	1.8	-	3.5	3.4	5	110
2B: Interim reports	22.8	46.5	18.4	5.3	1.8	5.2	4	108
2C: Direct information from banks	31.6	33.3	24.6	1.8	1.8	6.9	4	106
2D: Specialised publications	13.2	31.6	49.1	-	-	6.1	3	107
2E: Market rumours	0.9	14.9	49.1	24.6	3.5	6.9	3	106
2F: Advice from friends	6.1	42.1	37.7	4.4	2.6	6.9	4	106
2G: Stock market publications	44.7	23.7	21.1	1.8	2.6	6.1	4	107
4A: Public sector	17.5	36.0	21.9	14.0	2.6	8.0	4	105
4B: Private sector	17.5	45.6	27.2	0.9	-	8.8	4	104
4C: Both public and private sectors	63.2	6.1	12.3	4.4	12.3	1.8	4	112

Scale: 5= strongly agree, 1= strongly disagree

From Table 6.3, it can be seen that the median response varies between 3 and 5. Q2a has score 5 (strongly agree) for the importance of knowing the information source when dealing with Islamic banks. Table 6.3 shows that the users preferred the regulated accounting information (banks' annual reports) to unregulated ones (market rumours). This is clear when users who support regulated accounting standards with users who support unregulated information are compared. In more detail, responses to Q2a, Q2g Q2b, and Q2c, indicate strong support for the information based on a regulated form. Difference exist however as to the type of regulated information preferred. 55.3% of participants strongly agree with the annual reports (Q2a) with 36% in agreement whereas for direct information from banks (Q2c), 31.6%strongly agree and 33.3% agree.

In contrast, users of accounting information find less advantage in unregulated accounting information. Q2e and Q2f show that the users rely less on unregulated accounting information. Responses vary from 0.9% in strong agreement with market rumours (Q2e) with 14.9% in agreement to 6.1% in strong agreement with the advice from friends (Q2f) with 42.1% in agreement. Q2d seems to have been misunderstood or is less important compared with other regulated sources; this may be attributed to the lack of specialised publications in the area (Bahrain). 13.2% strongly agree and 31.6% agree with the importance specialist publications as important sources of accounting information.

When questioned about who should regulate accounting information, the respondents have no clear preference between the public and private sectors (52.5% for the public sector and 63.1% for the private sector). The main difference in this respect is in the degree of responses (17.5% strongly agree and 36.0% agree with the public sector and 17.5% strongly agree with the private sector with 45.6% in agreement. Evidently, both public and private sectors are acceptable as regulators. Q4c confirms this with 63.2% of respondents in strong agreement with regulation by both sectors and 6.1% in agreement.

Table 6.4 (Section one): Categorical scale

Question	Yes %	No %	Missing %	Valid cases
3: Regulating accounting information	100	0.0	0.0	114

Table 6.4 shows the result of question 3 which shows that 100% of respondents favour regulating accounting information. This result supports the reliance on regulated accounting information.

These results are consistent with results stated by Al- Hajji (2003) who concludes that more than 93% of respondents were in agreement with the regulation of accounting information by both private and public sectors in GCC countries. This result supports the policy adopted by the majority of developed countries, for instance, in the United States and the United Kingdom, where accounting information is regulated by the private sector with government supervision. In addition, questions 2a, 2b, and 2g show that users rely on official sources such as annual reports, interim reports and specialised publications as their main sources when dealing with Islamic banks compared with other sources such as market rumours or friend advice.

Table 6.5 shows a comparison between the perception of internal users (group1) and external users (group 2) compared with total users toward the usefulness of regulated accounting information.

Table 6.5: Comparison between internal and external groups about supporting the regulation of accounting information

Questions		Internal Users G1	Eternal Users G2	Both
Q2a: Bank annual reports	Median	5	5	5
	St Agree %	54.3	55.9	55.3
	Agree %	34.8	36.8	36.0
Q2b: Bank interim report	Median	4	4	4
	St Agree %	30.4	17.5	22.8
	Agree %	47.8	45.6	46.5
Q2c: Direct information from the bank	Median	4	4	4
	St Agree %	21.7	38.2	31.6
	Agree %	41.3	27.9	33.3
Q2d: Newspaper and business Magazine	Median	3	4	3
	St Agree %	15.2	11.8	13.2
	Agree %	17.4	41.2	31.6
Q2e: Market rumours	Median	3	3	3
	St Agree %	0.0	1.5	0.9
	Agree %	13.0	16.2	14.9
Q2f: Advice from friends	Median	4	3	4
	St Agree %	4.3	7.4	6.3
	Agree %	52.2	35.3	42.1
Q2g: Specialised publication (stock market)	Median	4.5	4	4
	St Agree%	47.8	42.6	44.7
	Agree %	19.6	26.5	23.7
Q3: Regulation of accounting Standards	Median	5	5	5
	St Agree %	100	100	100.0
	Agree %	100	100	100.0
Q4a: Private sector regulation	Median	4	4	4
	St Agree %	17.4	17.6	17.5
	Agree %	34.8	36.8	36.0
Q4b: Public sector regulation	Median	4	4	4
	St Agree %	21.7	14.7	17.5
	Agree %	39.1	50.0	45.6
Q4c: Private and public sector Regulation	Median	5	5	4
	St Agree %	58.7	66.2	63.2
	Agree %	8.7	4.4	6.1

Table 6.5 reveals that the two groups differ in their response to Q2b. 30.4% of internal users strongly agree with the importance of bank interim reports whereas 17.5 of the external users only are in strong agreement. The reason may be due to the lack of awareness of G2 with the importance of such vehicles as sources for the information. A significant contradiction is recorded between the two groups in Q2c. the comparison shows that G1 less strongly supported direct information from the banks (G1 = 21.7%, G2 = 38.2%). However, support from G1 is higher

at 41.3% compared with the G2 at 27.9%. Q2d further records significant differences in this respect. The responses in this question vary in the degree of supporting this item. G1 is more in favour of newspapers and business magazines than G2, the percentages are 17.4% in G1 and 41.2% in G2. Another significant variation is observed between two groups in Q2f, in this question, G1 are more likely to take advice from friends than G2 (G1 = 52.2%, G2 = 35.3%).

As to other items in this section the responses are in the main, similar and there are no notable differences. Therefore, in order to study the significant differences between the respondents of internal users (G1) and external users (G2) in this section, statistical instruments are applied in this study to measure such variation. Kruskal Wallis, One-Way Analysis (KW) and Mann-Whitney (U) are used to test the level of differences between the two groups because the groups that took part in the survey are in different size and users' perceptions were measured on an ordinal scale. A non-parametric test is found the most appropriate for such data (Huck and Cormier, 1996, Silver, 1997 and Siegel and Castellan, 1998).

Table 6.6: The level of significance between internal and external groups regarding their rating of the importance of different information sources

Items	Significant level
Q2A: Bank annual reports	.589
Q2B: Bank interim report	.085**
Q2C: Direct information from bank	.154
Q2D: Newspaper and business magazine	.076***
Q2E: Market rumours	.098*
Q2F: Advice from friends	.595
Q2G: Specialised publications	.992
Q4a: Regulating by public sector	.995
Q4b: Regulating by private sector	.914
Q4c: Regulating by private and public sector togetber	.445

Asymp sig. level of Mann-Whitney test of classifying groups: a ≤ 0.5 (2-tield)
sig at 10% level, ** sig at 5% level, * sig at 1% level.*

Table 6.6 reports that there is a degree of difference between internal and external groups regarding the importance they attach to various sources of information. The table shows that a high degree of an agreement is found for specialised publications, bank annual reports, and advice from friends. In contrast, the highest degree of difference among groups was found to be the bank interim report, markets rumours and direct information from the bank. These results coincide with results obtained by Al Hajji (2003). There is a high degree of 'contentment' for public sector to formulate accounting information, while the lowest differences exist between preferences for public or private sector regulation of financial information.

Part Two Section 2: Perception of users of financial statements toward applied accounting standards

This section answers research questions 3, 4, and 5 in this study. Table 6.7 deals with questions in categorical scale. This table shows the participants' answers to questions 5, 6 and 7 in the questionnaire. Question 5 investigates the awareness of the AAOIFI body, question 6 investigates whether the AAOIFI is qualified to establish accounting standards, and question 7 investigates individual awareness of the applicable accounting standards in Islamic banking in the sample. Table 6.8 notes the responses to questions classified in the Likert Scale and shows the respondents answer to questions 8, 9, 10 and 11. Question 8 asks individuals about which accounting standards the bank they deal with is following. Question 9 investigates the negative answer on question 7 about the accounting standards that should be followed in preparing financial statements. Question 10 examines the important aspects that should be considered when dealing with Islamic banks. Question 11 investigates the main factors that motivate customers to deal with Islamic banks in Bahrain.

Table 6.7: (Section two): Categorical scale

Question	Yes %	No %	Missing %	Valid cases
5: Idea about AAOIFI body	86.8	12.3	.9	113
6: Qualification of AAOIFI	90.4	6.1	3.5	110
7: Knowing the applicable accounting standards	81.6	16.7	1.8	112

From Table 6.7, it can be seen that questions 5, 6, and 7 reveal that most of the users contained the sample are aware of the accounting standards applied by Islamic banks in preparing their financial statements. Because of their professions, the users should be knowledgeable with the accounting standards used in preparing financial statements of Islamic banks. The high positive response about the accounting standards used may be due to the users' expertise or their education.

Table 6.8 Section two: Perception of financial statements preparers with applied accounting standards (Likert scale).

Qquestion	Str. Agree %	Agree %	Indifferent %	Disagree %	Str. Disagree %	Missing %	median	Valid cases
8A: Apply IAS	38.6	29.8	11.4	-	-	10.5	4	92
8B: Apply AAOIFI	64.0	8.8	7.9	-	-	10.5	5	92
8C: Apply local accounting standards	5.3	15.8	41.2	1.8	9.6	26.3	3	84
9A: Should apply IAS	8.8	3.5	1.8	-	-	85.9	5	16
9B: Should apply AAOIFI	7.9	0.9	5.3	-	-	85.9	5	16
9C: Should apply local accounting st	0.9	3.5	6.1	3.5	-	85.9	3	16
10A: Reputation of Islamic banks	82.5	13.2	0.9	0.9	2.6	0.0	5	114
10B: Applying AAOIFI standards	58.5	23.7	10.5	-	5.3	1.8	5	112
10C: The name contains the word "Islamic"	6.1	15.8	43.0	20.2	12.3	2.6	3	111
10D: High profit	35.1	44.7	9.6	5.3	2.6	2.6	4	111
10E: Only Islamic productions	64.9	14.9	13.2	-	6.1	0.9	5	113
11A: Following *Sharia'h* precepts	91.2	6.1	2.6	-	-	0.0	6	114
11B: The name contains the word "Islamic"	7.0	35.1	25.4	16.7	14.0	1.8	3	112
11C: Applying AAOIFI standards	22.8	27.2	24.6	18.4	6.1	0.9	4	113
11D: Reputation	78.1	16.7	2,6	-	1.8	0.9	5	113
11E: Performing high profit	43.9	17.5	11.4	7.0	18.8	1.8	4	112
11F: Existing in different areas	50.0	29.8	10.5	7.9	-	1.8	5	112
11G: Periodic profit distribution	54.4	36.0	4.4	0.9	1.8	2.6	5	111
11H: Services quality	87.7	8.8	1.8	-	-	1.8	5	112

Scale: 5= strongly agree, 1= strongly disagree

Table 6.8, questions 8, 9, 10, and 11 illustrates the users' perception about the applied accounting standards. These questions reveal whether the users deal with Islamic banks because of specific accounting standards or for other characteristics that exist in these banks. Consequently, Table 6.8 exhibits the following findings: from the first glance, it can be seen that responses of Q11a record the highest positive response which means that the users support the Islamic banks because they follow the *Sharia'h* precepts more than any other reasons. The quality of services and the reputation of Islamic banks are the secondary concern of users. This may be due to abiding by *Sharia'h* law in producing only Islamic products. Questions 8b, 10b, show respectively 64%, 82.5% strongly agree and 8.8%, 13.2% agree know that Islamic banks are applying AAOIFI standards and the median of these questions is 5 as shown in Table 6.8.

However, the study reveals that there is a negative impact resulting from the name of Islamic banks as an indication of the Islamisation of its production, respondents on Q10c and Q11b demonstrate these results (Q10c = 6.1% strongly agree, 15.8% agree and Q11c = 7.0% strongly agree, 35.1% agree). This finding contradicts with findings approved by Nasser (1999) who stated that the existence of the word "Islamic" in the name of the bank encourages dealings with bank.

According to the impact resulting from applying AAOIFI standards, the analysis reveals that the importance of such factors is varies between Q10b and Q11c. The responses to Q10c show that the users support using AAOIFI standards in preparing financial statements, meanwhile Q11b did not. This contradiction may indicate the lack of importance of this factor. Q8a questions about the implementation of accounting standards showing that 68.4% of respondents believe that the International Accounting Standards (IAS) are the standards used in preparing financial statements. This result contradicts with what the Bahrain Monetary Agency (BMA) declared in this respect. This may reflect the usefulness degree of the used standards. This result also contradicts with the annual reports declaration regarding the use of the AAOIFI standards as the applied standards (content analysis results).

This study surveys the impact on different groups of the awareness of the accounting standards used in preparing financial statements and whether these accounting standards influence the decision of the users to deal with these banks.

Accordingly, Table 6.9 and Table 6.10 show the attitude of internal and external users toward these points.

Table 6.9: Comparison between internal and external groups about supporting the regulation of accounting information

Questions		Internal Users G1	Eternal Users G2	Both
8A: Applying IAS	Median	5	4	4
	St Agree %	42.6	32.6	38.6
	Agree %	32.4	26.1	29.8
8B; Applying AAOIFI	Median	5	5	5
	St Agree %	67.6	58.7	64.0
	Agree %	10.3	6.5	8.8
8C: Applying local accounting standards	Median	3	3	3
	St Agree %	7.4	2.2	5.3
	Agree %	11.8	21.7	15.8
9A; Should apply IAS	Median	5	5	5
	St Agree %	7.4	10.9	8.8
	Agree %	2.9	4.3	3.5
9B: Should apply AAOIFI	Median	5	3.5	5
	St Agree %	8.8	6.5	7.9
	Agree %	-	2.2	0.9
9C: Should applying local accounting standards	Median	3	3	3
	St Agree %	1.5	-	0.9
	Agree %	4.4	2.2	3.5
10A: Islamic banks reputation	Median	5	5	5
	St Agree%	86.8	76.1	82.5
	Agree %	10.3	17.4	13.2
10B: Applying AAOIFI	Median	5	5	5
	St Agree %	55.9	63.0	58.5
	Agree %	25.0	21.7	23.7
10C: Its name contains the word "Islamic"	Median	3	3	3
	St Agree %	7.4	4.3	6.1
	Agree %	19.1	10.9	15.9
10D: Performing high profit	Median	4	4	4
	St Agree %	33.8	37.0	35.1
	Agree %	48.5	39.1	44.7
10E: Providing Islamic products only	Median	5	5	5
	St Agree %	58.9	73.9	64.9
	Agree %	17.6	10.9	14.9

Scale: 5= strongly Agree, 1= strongly disagree

Table 6.9 shows the comparison of each group and the total. From Table 6.9, it can be seen that the respondents of G1 score equally for both strong agreement and agreement on Q10c. This question asks whether Islamic banks which contain the word "Islamic" attract individuals to deal with banks.

Table 6.10: Comparison between internal and external groups about supporting the regulation of accounting information

Question		Internal Users G1	Eternal Users G2	Both
11A: Following *Sharia'h* precepts	Median	5	5	5
	St Agree %	91.2	91.3	91.2
	Agree %	8.8	2.2	6.1
11B: Its name contains the word "Islamic"	Median	4	3	3
	St Agree %	11.8	4.3	7.0
	Agree %	39.7	37.0	35.1
11C: Applying AAOIFI	Median	4	3	4
	St Agree %	22.1	23.9	22.8
	Agree %	35.3	15.2	27.2
11D: Reputation of Islamic bank	Median	5	5	5
	St Agree %	85.3	67.4	78.1
	Agree %	10.3	26.1	16.7
11E: Performing high profits	Median	4	4	4
	St Agree %	45.6	41.3	43.9
	Agree %	13.2	23.9	17.5
11F: Existing in different areas	Median	5	4	5
	St Agree %	52.9	45.7	50.0
	Agree %	27.9	32.6	29.8
11G: Periodic profit distribution	Median	5	4	5
	St Agree %	61.8	43.5	54.4
	Agree %	33.8	39.1	36.0
11H: Service quality	Median	5	5	5
	St Agree %	92.6	88.4	87.7
	Agree %	5.9	13.0	8.8

Scale: 5= strongly agree, 1= strongly disagree

At first glance, Q11a in Table 6.10 shows that 100% of internal users believe that following *Sharia'h* precepts is the main factor that attracts individuals to deal with Islamic banks (91.2% strongly agree and 8.8% agree). This was supported by external users, but to a lesser degree (93.5%). With regard to the questions about the applied accounting standards, both internal and external users are in confusion between IAS and AAOIFI. However, in some degree, the external and internal users strongly reported that the AAOIFI standards are the applied standards. Differences in the degree of responses are recorded between two groups in Q11c, 11d and 11g.

However, according to the implementation of accounting standards, in fact Islamic banks operating in the state of Bahrain are applying AAOIFI. This was clear and examined in this study when performing the content analysis. The Bahrain Monetary Agency (BMA) has circulated a decree which obliges the Islamic banks operating in Bahrain to apply AAOIFI standards in preparing their financial statements (Islamic Banking & Finance, 2002). However, the users of financial statements are in confusion about the applied standards in preparing financial statements. The previous result is also in contradiction with what the annual report declared. These annual reports declare that the AAOIFI is the applied accounting standard. This result supports what this study stated previously about the lack of awareness of AAOIFI standards. Furthermore this result has been proved by findings of Q9a and Q9b. Both internal and external users were confused between IAS and AAOIFI as ideal accounting standards. Internal users have low attention regarding this point, only 10.3% support IAS and 8.8% support AAOIFI, while 8.7% support IAS and 2.2% support AAOIFI from the group of external users. This indicates the ineffectiveness of this factor to attract individuals to deal with Islamic banks.

With regarding to the impact resulting from applying AAOIFI to encourage individuals to deal with Islamic banks, Table 6.10 shows in Q11c less impact of this factor among external users (23.9% strongly agree, 15.2% agree). Meanwhile, the internal group (22.1% strongly agree, 35.3% agree) supported this factor. This result supports previous finding in Q8b. One noteworthy observation is about whether the periodic profit distribution increases attractiveness. Internal users are more optimistic than the external users, 61.8% strongly agree as opposed to 43.5% in Q11g.

From the above, it can be concluded that this section revealed the need for a qualified organisation to set and supervise accounting information; this would help them to achieve objective 3. The awareness of the existence of AAOIFI was also raised in this section (objective 4). The main feature which encourages people to deal with Islamic banks is the *Sharia'h* Supervisory Board. This plays a crucial role in purifying the Islamic banking transactions from any prohibited transactions which are inconsistent with Islamic *Sharia'h* precepts. This is revealed in the SSB report contained in the annual reports. Furthermore, the users refused to admit that the reason behind they dealt with Islamic banks was because they contained the word "Islamic".

Indeed, Table 6.8 shows that only 15.8% have agreed to this reason in question 8c. Meanwhile this percentage rose to 42.1% in question 11b. These two findings fulfil objective 7 which investigate the importance of accounting standards used in preparing financial statements of Islamic banks and whether these standards correspond with *Sharia'h* law. The findings of this point are not clear (objective 6). However, question 8c clearly showed that the majority refuse to apply local accounting standards in preparing financial statements of Islamic banks (only 5.3% strongly agree and 15.8 agree). Table 6.9 shows that both internal and external users were confused between IAS and AAOIFI as ideal accounting standards if they have no idea about the accounting standards that are applied. Internal users have low attention regarding this point.

Statistical tests

Statistical analysis, in this respect, measures variation in the answers to questions received from groups, regardless of whether these answers are negative or positive. The following table uses the Mann-Whitney test to find out the significant differences between respondents of the two groups about the perception of financial statements preparers of applied accounting standards. Table 6.11 shows the highest and lowest significant degrees of differences.

Table 6.11: The level of significance between internal and external groups regarding their rating of the awareness with AAOIFI

Items	Significant level
Q8a: Applying IAS accounting standards	**.152**
Q8b: Applying AAOIFI accounting standards	**.592**
Q8c: Applying local accounting standards	**.404**
Q10a: Reputation of bank	**.143**
Q10b: Applying AAOIFI	**.542**
Q10c: Named Islamic	**.373**
Q10d: Performing high profit	**.892**
Q10e: Producing only Islamic services	**.115**
Q11a: Following *Sharia'h* precepts	**.943**
Q11b: Its name contains the word "Islamic"	**.041****
Q11f: Existing in different areas	**.547**
Q11g: Periodic profit distribution	**.006*****
Q11h: Service quality	**.044****

Asymp sig. level of Mann-Whitney test of classifying groups: α ≤ 0.05 (2-taeld).
sig at 10% level, ** sig at 5% level, *** sig at 1% level.

Table 6.11 shows there are no significant differences between the internal and external groups regarding the awareness of AAOIFI as an independent organisation. The scores in Table 6.11 indicate that there are differences between the groups with regard to the following; periodic profit distribution, the name contains the word "Islamic" and service quality. Meanwhile, there is no significant difference between the groups regarding following *Sharia'h* precepts, performing high profit and existing in different areas. Statistical analysis however does not produce a strong effect from the received results. Therefore, the results which are set out in the previous tables explain the attitude of internal and external users toward the AAOIFI organisation and its role in encouraging individuals to deal with Islamic banks.

Part Two, Section 3: Investigating the extent of applying the AAOIFI standards.

According to the results gained from the content analysis, all Islamic banks, operating in the state of Bahrain, are applying AAOIFI standards in preparing their financial statements. This section is designed to answer study questions 7 and 8. Accordingly, Tables 6.12, 6.13, 6.14, 6.15, 6.16, 6.17, 6.18 and 6.19 attempt to verify whether AAOIFI standards are suitable for preparing useful financial statements and the users' attitude toward the usefulness of such statements in meeting their needs. Table 6.12 shows the responses to question 7 which investigate the awareness of accounting standards used in Islamic banks.

Table 6.12: (Section three): Categorical scale

Question	Yes %	No %	Missing %	Valid cases
7: Knowing the applicable accounting standards	86.8	12.3	0.9	113

Table 6.12 shows questions figured in categorical scale. The result shows that the majority of financial statements users are aware of the applicable accounting standards in Islamic banking (Q7). More than 86% of the respondents are positive respondents as stated in the previous section. However, this result does not reflect the respondents answers collected on Q8a, Q8b. In these two questions, the responses become over-lapped which mean that the users are in confusion between International Accounting Standards (IAS) and Accounting and Auditing Organisation for Islamic Financial Institution (AAOIFI) standards.

Table 6.13 (Section three): Applying AAOIFI standards (Likert scale)

Question	Str. Agree %	Agree %	Indifferent %	Disagree %	Str. Disagree %	Missing %	median	Valid cases
8A: IAS	38.6	29.8	11.4	-	-	19.3	4	92
8B: AAOIFI	64.8	8.8	7.9	-	-	19.3	5	92
8C: local accounting standards	5.3	15.8	41.2	1.8	9.6	26.3	3	84
9A: Should be IAS	8.8	3.5	1.8	-	-	86.0	5	16
9B: Should be AAOIFI	7.9	0.9	5.3	-	-	86.0	5	16
9C: Should be local accounting st	0.9	3.5	6.1	3.5	-	86.0	3	16
10A: Reputation of Islamic banks	82.5	13.2	0.9	0.9	2.6	0.0	5	114
10B: Applying AAOIFI standards	58.8	23.7	10.5	-	5.3	1.8	5	112
10C: The name contains the word "Islamic"	6.1	15.8	43.0	20.2	12.3	2.7	3	111
10D: High profit	35.1	44.7	9.6	5.3	2.6	2.7	4	111
10E: Only Islamic productions	64.9	14.9	13.2	-	6.1	0.9	5	113
11A: Following *Sharia'h* precepts	91.2	6.1	2.6	-	-	0.0	5	114
11B: The name contain " Islamic"	8.8	38.6	25.4	12.3	13.2	1.8	3	112
11C: Applying AAOIFI standards	22.8	27.2	24.6	18.4	6.1	0.9	4	113
11D: Reputation	78.1	16.7	2.6	-	1.8	0.9	5	113
11E: Performing high profit	43.9	17.5	11.4	7.0	18.4	1.8	5	112
11F: Existing in different area	50.0	29.8	10.5	7.9	-	1.8	5	112
11G: Periodic profit distribution	54.4	36.0	4.4	0.9	1.8	2.7	3	111
11H: Services quality	87.7	8.8	1.8	-	-	1.8	5	112

Scale: 5= strongly agree, 1= strongly disagree

Table 6.13 shows questions 8, 9, 10, 11, 12 and 19. The first three questions were explained earlier, question 12 examines the effect of items contained within annual reports on decision making while question 19 examines the sufficient disclosure in the items contained the annual report of Islamic banks. Table 6.14

meanwhile treats questions classified in ranking scale. Question 15 investigates which item is the most important in the annual report. Question 16 examines the SSB report content. Question 17 examines the information that the *Zakat* statement contained. And finally, Question 18 examines the information the *Alqard* statement contained.

The results presented in Tables 6.13 and 6.14 indicate that the median of most respondents was between 4 and 5, which indicate that the respondents flow in one direction. Table 6.13 shows that the majority of users of financial statements of Islamic banks have had knowledge of the accounting standards used in preparing financial statements of these banks as stated in the previous section.

Table 6.14 (Section Three): Applying AAOIFI standards (Likert scale)

Question	Str. Agree%	Agree %	Indifferent %	Disagree %	Str. Disagree %	Missing %	median	Valid cases
12A: Chairman report	10.5	19.3	16.7	24.6	24.6	4.4	4	109
12B: SSB report	72.8	21.1	5.3	-	-	0.9	5	113
12C: Auditor report	81.6	12.3	3.5	-	-	0.9	5	113
12D: Board of director report	4.4	5.3	21.1	41.2	24.6	3.5	2	110
12E: Balance sheet	71.1	22.8	1.8	0.9	2.6	0.9	5	113
12F: Income statement	75.4	20.2	0.9	-	1.8	1.8	5	112
12G: Changing in shareholder eq	31.6	27.2	24.6	10.5	-	6.1	4	107
12H: Cash flow statement	24.6	37.7	6.1	13.2	13.2	5.3	4	108
12I: *Zakat* statement	17.5	36.8	31.5	0.9	6.1	7.0	4	106
12J: Al Qard statement	7.9	16.7	25.4	30.7	12.3	7.0	3	106
12K: Changing in unrestricted acc	13.2	30.7	25.4	11.4	12.3	7.0	4	106
19A: Chairman report	29.8	38.6	2.2	8.8	1.8	0.9	3	113
19B: SSB report	62.3	24.6	7.0	2.6	3.5	0.0	5	114
19C: Auditor report	72.8	12.3	14.0	-	0.9	0.0	5	114
19H: *Zakat* statement	17.5	47.4	28.1	1.8	4.4	0.9	4	113
19I: Al Qard statement	15.8	45.6	27.2	4.4	5.3	1.8	4	112

Scale: 5= strongly agree, 1= strongly disagree

The remarkable results contained in the Table 6.14 indicate that the statement of changing in shareholders equity (Q12f) is more useful compared to others, 75.4% strongly support using this statement and 20.2% supporting the use of the statement. The balance sheet comes in the second position in users' preference in this survey; 71.1% strongly agree to support such a statement and 22.8% agree to support it (Q12e). The users are focusing on the reports contained in the annual reports. In this respect, Table 6.14 shows that both the *Sharia'h* supervisory report and the audit report are useful in decision making; 72.8% and 81.6% of users strongly agreed to support the usefulness of both reports and 21.1% and 12.3% agree to support these reports (Q12b, Q12c respectively).

In contrast, Table 6.14 shows less contentment when valuing the items contained in some parts of Islamic banks' annual reports. The results indicate that the Board of Directors Report has the lowest support, (4.4% strongly agree and 5.3% agree on Q12d). This means that this report is not important in decision making. The second weakest item is the Chairman's Report, only 19.5% strongly support such a report and 19.3% agree to support it. The statement of changes in unrestricted investment accounts (Q12j) has the lowest support, only 12.3% of users strongly agree with the usefulness of this statement, while 41.2% agree. The *Alqard Alhassan* statement is shown to have the least usefulness, Table 6.14 shows that 14.9% strongly agree about the usefulness of the statement. This result is supported in Q19i. Furthermore, the results in Table 6.14 indicate that these are useless items in the Annual Report. Q16c indicates that only 13.2% approve of referring to the treatment of client insolvencies. This may contradict with the approved disclosure in these items.

Table 6.15: (Section Three): Applying AAOIFI standards (Ranking scale)

Question	Very important %	important %	indifferent %	Not important %	Not important at all %	missing %	median	Valid cases
Q1	57.0	35.1	1.8	0.9	5.3	0.0	5	114
15B: Referring to calculating method	34.2	55.3	4.4	1.8	4.4	0.0	4	114
15C: Treating impairment assets	52.6	36.8	4.4	1.8	4.4	0.0	5	114
15D: Amount of impairment assets	55.3	32.5	7.0	0.9	4.4	0.0	5	114
15E: Level of disclosure	84.2	14.9	-	-	0.9	0.0	5	114
16A: Importance of SSB report	74.6	15.8	8.8	0.9	-	0.0	5	114
16B: Referring to ex-ante auditing	57.9	25.3	9.6	1.8	4.4	0.0	5	114
16C: Refer to treat client insolvency	13.2	52.6	22.8	7.0	4.4	0.0	4	114
16D: Refer to non-Islamic income	57.0	30.7	7.9	3.5	0.9	0.0	5	114
16E: Refer to use of non-Islamic income	54.4	29.8	13.2	1.8	0.9	0.0	5	114
16F: :Level of disclosure in SSB report	78.1	15.8	4.4	0.9	-	0.9	5	113
17A: Important of *Zakat* statement	58.8	23.7	8.8	0.9	7.9	0.0	5	114
17B: Refer to how calculate *Zakat*	54.4	30.7	7.9	0.9	6.1	0.0	5	114
17C: Refer to the source of *Zakat* fund	44.7	43.0	11.4	-	-	0.9	4	113
17D: Refer to the use of *Zakat* fund	37.7	44.7	10.5	5.3	1.8	0.0	4	114
17E: Level of disclosure in *Zakat* stat	63.2	21.9	11.4	-	1.8	0.9	5	113
18A: Important of *Alqard* statement	34.2	50.9	6.1	-	7.9	0.9	4	113
18B: Refer to the source in *Alqard* stat	35.1	48.2	7.9	-	7.9	0.9	4	113
18C: Refer to the use of Alqard fund	36.8	51.8	2.6	-	7.9	0.9	4	113
18D: Level of disclosure in *Alqard* state	27.2	57.0	4.4	1.8	7.9	1.8	4	112

Scale: 5= very important, 1=not important at all

Table 6.15 exhibits the ranking scale. The results show that the users prefer the disclosure in financial statements as the most important items which means that the users aware with the important of the disclosure in providing relevant information. Q15e shows that the users recommend the disclosure when calculating provisions and reserves, (84.2% very important and 14.9% important). In addition, 78.1% rank as very important and 15.8% as important the disclosure in SSB report (Q16f). The third significant notable disclosure percentage shows that 63.2% rank as very important and 21.9% as important the level of disclosure in the *Zakat* statement (Q17e). The level of disclosure in the *Alqard* statement is shown as less important. This may be due to the importance of such statements in decision making. This result is also consistent with the result on Q12j in table 6.14. The users also support the importance of the *Sharia'h* Supervisory Report as the most important item contained within the annual report. Table 6.15 reveals that 74.6% of the respondents regard this report as very important and 21.9% regard the report as important. This result supports the previous result in section two. Regarding the importance of calculating provisions and reserves; *ex-ante* SSB auditing, non-Islamic income and the *Zakat* statement refer to the amount of impairment assets. The results show a similar positive recommendation, the average of very important is 57% and important 30s% in this respect.

Tables 6.16 and Table 6.17 present a comparison between the way information was collected from group 1 and group 2. It is important to mention that Table 6.16 contains Likert scale questions and does not contain the questions that have been handled in previous sections (from Q7 to Q11h). The table contains quite similar responses. The remarkable difference in this part is the importance of the cash flow statement in decision making (Q12h). 30.9% strongly agree from amongst internal users compared with 15.2% and 27.9% who agree to support this item compared with 52.2% from external users. This contradiction may be due to the greater familiarity of the internal group with the importance of such a statement in estimating and evaluating the cash flow statement.

Table 6.16: Comparison between internal and external groups about supporting the regulation of accounting information

Question		Internal users G1	Eternal users G2	Both
12A: Usefulness of chairman report	Median	3.5	4	4
	St Agree %	13.2	6.5	35.1
	Agree %	19.1	19.6	42.1
12B: Usefulness of SSB report	Median	5	5	5
	St Agree %	75.0	69.6	72.8
	Agree %	20.6	21.7	21.1
12C: Usefulness of auditor report	Median	5	5	5
	St Agree %	82.4	80.4	72.8
	Agree %	13.2	10.9	21.1
12D: Usefulness of board of director report	Median	4	4	4
	St Agree %	4.4	4.3	28.9
	Agree %	5.9	4.3	46.5
12E: Usefulness of balance sheet	Median	5	5	5
	St Agree %	75.0	65.2	74.6
	Agree %	22.1	23.9	22.8
12F: Useful of income statement	Median	5	5	5
	St Agree %	76.5	73.9	77.2
	Agree %	20.6	19.6	20.2
12G: Usefulness of statement of changes in shareholder equity	Median	4	4	4
	St Agree %	35.3	26.1	47.4
	Agree %	20.6	37.0	25.4
12H: Usefulness of cash flow statement	Median	4	4	4
	St Agree %	30.9	15.2	24.6
	Agree %	27.9	52.2	37.7
12I: Usefulness of *Zakat* statement	Median	4	4	4
	St Agree %	13.2	23.9	33.3
	Agree %	35.3	37.0	49.1
12J: Usefulness of *Alqard Alhassan* statement	Median	3	4	4
	St Agree %	8.8	6.5	17.5
	Agree %	19.1	13.0	36.8
12K: Usefulness of statement of changes in unrestricted investment	Median	3	3	4
	St Agree %	10,3	17.4	12.3
	Agree %	35.3	23.9	41.2
19A: Sufficient disclosure in chairman report	Median	4	4	4
	St Agree %	29.4	30.4	18.4
	Agree %	47.1	26.1	40.4
19B: Sufficient disclosure in SSB report	Median	5	5	5
	St Agree %	63.2	60.9	62.3
	Agree %	26.5	21.7	25.4
19C: Sufficient disclosure in auditor report	Median	5	5	4
	St Agree %	76.5	67.4	17.5
	Agree %	11.8	13.0	48.2
19H: Sufficient disclosure in *Zakat* Statement	Median	4	4	5
	St Agree %	17.6	17.4	63.2
	Agree %	51.5	41.3	21.9
19I: Sufficient disclosure in *Alqard Alhassan* statement	Median	4	4	4
	St Agree %	13.2	19.6	14.9
	Agree %	52.9	34.8	45.6

Scale: 5= strongly agree, 1= strongly disagree

From Table 6.17 and 6.18 it can be seen that the respondents, in general, flow in the same direction. The main differences between respondents of G1 and G2 can be seen in Table 6.17, (Q16a the importance of the SSB report). The majority of G1 states that the SSB is very important (82.4%) while within G2 only 65.2% state that the report is very important. A slight difference between the groups revealed in Q16c. G1 respondents shows that 60.3% agree about the importance of referring to the treatment of client insolvency in the SSB report, but G2 respondents show that only 41.3% agreed about the importance of this procedure. The third notable difference exists in Q18c about referring to the usage of *Alqard* funds. 32.3% of G1 stated it was very important to mention the usage of the *Alqard* fund in the annual report; meanwhile this percentage exceeded 50% for G2 on the point of very important agreeing with this procedure.

Table 6.17: Comparison between internal and external groups about investigating the extent of applying AAOIFI standards

Questions		Internal users G1	Eternal users G2	Both
15A: Calculating provision and reserves on the impairment assets	Median	5	4.5	5
	V. impo %	61.8	50.0	57.0
	Impo %	30.9	41.3	35.1
15B: Referring to the method of calculating provisions	Median	4	4	4
	V. impo %	35.3	30.4	34.2
	Impo %	54.4	56.5	55.3
15C: Referring to the treatment of impairment assets	Median	5	5	5
	V. impo %	51.5	60.9	52.6
	Impo %	36.8	26.1	36.8
15d: Referring to the amount of impairment assets	Median	4	5	5
	V. impo %	48.5	58.7	55.3
	Impo %	39.7	32.6	32.5
15E: The level of disclosure about the provisions	Median	5	5	5
	V. impo %	85.3	82.6	84.2
	Impo %	13.2	17.4	14.9
16A: The importance of the SSB report	Median	5	5	5
	V. impo %	82.4	65.2	74.6
	Impo %	13.2	17.4	15.8
16B: Referring to ex ante auditing the contracts in SSB	Median	5	5	5
	V. impo %	57.4	60.9	57.9
	Impo %	27.9	21.7	25.3
16C: Referring to the treatment of insolvency clients in SSB	Median	4	4	4
	V. impo %	14.7	13.0	13.2
	Impo %	60.3	41.3	52.6
16D: Referring to sources of non-Islamic income in SSB	Median	5	5	5
	V. impo %	60.3	54.3	57.0
	Impo %	30.9	28.3	30.7
16E: Referring to the use of non-Islamic income in SSB	Median	5	4	5
	V. impo %	57.4	45.7	54.4
	Impo %	32.4	23.9	29.8
16F: The level of disclosure in the SSB report	Median	5	4	5
	V. impo %	54.4	45.7	78.1
	Impo %	11.8	10.9	15.8

Scale: 5= Very important, 1= not important at all

Table 6.18 shows that the respondents do not reveal any significant differences on question 17 and question 18. A slight difference exists between the two groups on Q18c which refers to the use of *Alqard* Funds. Table 6.18 shows that only 32.4% of G1 state that the use of *Alqard* funds is very important while 50% believe this to be so. However, the total refers that about 37% supporting the importance of Alqard funds in both groups.

Table 6.18: Comparison between internal and external groups about investigating the extent of applying AAOIFI standards

Questions		Internal users G1	Eternal users G2	Both
17A:The Importance of the *Zakat* Statement	Median	5	5	5
	V. impo %	52.9	56.5	58.8
	Impo %	25.0	17.4	23.7
17B: Referring to how calculating *Zakat*	Median	5	5	5
	V. impo %	52.9	56.5	54.4
	Impo %	33.8	26.1	30.7
17C: Referring to the sources of *Zakat* funds	Median	4	4	4
	V. impo %	47.8	41.3	44.7
	Impo %	44.1	41.3	43.0
17D: Referring to the uses of *Zakat* Funds	Median	4	4	4
	V. impo %	36.8	39.1	37.7
	Impo %	47.1	41.3	44.7
17E: The level of disclosure in *Zakat* statement	Median	5	5	5
	V. impo %	60.3	60.9	63.2
	Impo %	25.0	19.6	21.9
18A: The importance of the *Alqard* Statement	Median	4	4	4
	V. impo %	33.8	39.1	34.2
	Impo %	52.9	45.7	50.9
18B: Referring to the sources of *Alqard* funds	Median	4	4	4
	V. impo %	33.8	43.5	35.1
	Impo %	48.5	43.5	48.2
18C: Referring to the use of *Alqard* funds	Median	4	5	4
	V. impo %	32.4	50.0	36.8
	Impo %	55.9	41.3	51.8
18D: The level of disclosure in *Alqard* statement	Median	4	4	4
	V. impo %	26.5	34.8	27.2
	Impo %	58.8	50.0	57.0

Scale: 5= Very important, 1= not important at all

Statistical test

The statistical Mann-Whitney *U* test (which is shown below in Table 6.19) suggests that there are no significant differences between internal and external groups. The exception is in two items: the first item is about the importance of the SSB report; this was supported earlier when the comparison method was used, and this may be due to the weight of the internal users who support the importance of such report more than the external group. In addition, this may be due to the familiarity of internal group with the significance of the SSB report. The second significant difference refers to the disposal of the non-Islamic income in the SSB report. It is worth noting, and has been mentioned earlier, that the purpose of the SSB report is to provide an assurance that the Islamic banks operate within *Sharia'h* principles. In this respect, it can be seen that the internal users are more aware of such a requirement than external users and this awareness may make the information contained in the annual reports more useful in decision making.

Table 6.19: The level of significance between the internal and the external groups regarding their rating of the awareness of AAOIFI

Items	Significant level
Q15a: The importance of calculating provision and reserves	.251
Q15b: Referring to the method of calculating provision	.557
Q15c: Referring to treatment of insolvencies	.398
Q15d: Referring to the impairment assets	.268
Q15e: Referring to the level of provision disclosure	.728
Q16a: The importance of the SSB report	.027**
Q16b: Referring to the ex ante auditing	.791
Q16c: SSB referring to the treatment of insolvency clients	.105
Q16d: SSB referring to the source Of non-Islamic income	.368
Q16e: SSB referring to the use of non-Islamic income	.043**
Q16f: Level of SSB disclosure	.397
Q17a: The important of *Zakat* statement	.869
Q17b: Referring to how is *Zakat* calculated	.792
Q17c: Referring to *Zakat* source	.268
Q17d: Referring to *Zakat* use	.923
Q17e: Referring to the level of disclosure	.715
Q18a: The important of *Alqard Alhassan* statement	.561
Q18b: Referring to the *Alqard* source.	.194
Q18c: Referring to the use of *Alqard* fund.	.045**
Q18d: Referring to the level of disclosure in *Alqard* statement	.409

Asym sig. level of Mann-Whitney test of classifying groups: a ≤ .05 (2-tield)
sig at 10% level, ** sig at 5% level, * sig at 1% level.*

Table 6.19 shows that there is a significant difference existing in the perception of the importance of the SSB report. The score recorded here is 0.027%. In addition, another significant difference exists in referring to the use of non-Islamic income. This difference among the internal and external users may be due to their awareness about the importance of such items. A significant difference among the users was recorded with reference to the use of *Alqard Alhassan* fund. This difference coincides with the users' attitude toward the existence of the *Alqard* statement.

Part Two, Section 4: General impression about the annual reports after applying AAOIFI standard

One of the main aims of this study is to discover the extent of users' satisfaction about the usefulness of annual reports in decision making. Section four investigates the impression of the users about the annual reports of Islamic banks after applying AAOIFI standards and attempts to answer research question No 9. Accordingly, questions 10, 11 and 13 in Table 6.20 and questions 20, 21 and 22 are employed to investigate this aim. Question 10 examines the important aspects that should be considered when dealing with Islamic banks. Question 11 investigates the main factors that motivate customers to deal with Islamic banks in Bahrain. Question 13 examines the characteristics of the financial information contained in the annual reports of Islamic banks.

Table 6.20 (Section four): General impression about the annual reports after applying AAOIFI standards (Likert scale)

Question	Str. Agree %	Agree %	Indifferent %	Disagree %	Str. Disagree %	Missing %	median	Valid cases
10A: Reputation of Islamic banks	83.3	13.2	0.9	0.9	1.8	1.25	5	114
10B: Applying AAOIFI standards	58.8	23.7	10.5	-	5.3	1.67	5	112
10C: The name contains the word "Islamic"	36.0	45.6	9.6	4.4	1.8	1.87	4	111
10D: High profit	6.1	14.9	43.0	21.1	12.3	3.19	3	111
10E: Only Islamic productions	64.0	14.9	13.2	-	7.0	1.70	5	113
11A: Following *Sharia'h* precepts	91.2	6.1	2.6	-	-	1.11	5	114
11B: The name contains the word "Islamic"	7.0	35.1	25.4	16.7	14.0	2.96	3	112
11C: Applying AAOIFI standards	26.3	39.5	21.1	7.0	5.3	2.25	4	113
11D: Reputation	79.8	16.7	2.6	-	--	1.22	5	113
11E: Performing high profit	62.3	24.6	11.4	-	-	1.48	5	112
11F: Existing in different area	49.1	30.7	10.5	7.9	-	1.77	4.5	112
11H: Services quality	87.7	8.8	1.8	-	-	1.13	5	112
13A: Easy presenting	74.6	19.3	6.1	-	-	1.32	5	114
13B: punctuality of information	54.4	39.5	4.4	-	-	1.49	5	112
13C:Nneutrality	66.7	23.7	4.4	0.9	4.4	1.53	5	114
13D: Credibility	74.6	14.9	2.6	2.6	3.5	1.43	5	112
13E: Comparability	61.4	30.7	7.0	-	.9	1.48	5	114
13F: Ease of collection of information	50.9	28.9	12.3	0.9	4.4	1.76	5	111
13G: Independence agency confirmed	64.9	20.2	7.9	1.8	3.5	1.56	5	112

Scale: 5= strongly agree, 1= strongly disagree

From Table 6.20, it can be seen that the majority of users are satisfied with the published financial reports. Q11a, Q11h, Q10a and Q11d recommended these annual reports. When questioned, the main factor that motivates customers to deal with Islamic banks is shown to be adherence to *Sharia'h* precepts with 91.2% in strong agreement and 6.1% in agreement. The high response may be due to the fact that Muslims believe that the role of Islamic banks is to take them away from prohibited transactions. This factor was shown in Q10a to be the main factor that should be considered when dealing with Islamic banks; 83.3% strongly agreed and 13.2% agree with this factor. In addition, service quality and simplicity of presenting information are factors that motivate customers to deal with Islamic banks, 87.7%, 74.6% strongly agreed and 8.8%, 19.3% agreed respectively.

The table 6.20 shows that Q10c and Q11b have negative responses. Both of these questions ask participants about whether the name of Islamic banks affects clients decisions to deal with them. The responses indicate that the customers have good knowledge about the Islamic banks and this was also supported in part one, when talking about the education and experience of participants.

Table 6.21 (Section four): Ranking scale

Q	Very important %	important %	indifferent %	Not important %	Not important at all %	missing %	median	Valid cases
20: Degree of applicable application	25.4	58.8	14.9	-	-	0.9	4	113
21: Degree of satisfaction	27.2	58.8	13.2	0.9	-	0.0	4	114
22: Degree of recommendation	72.8	19.3	6.1	-	1.8	0.0	5	114

Scale: 5= very important, 1=not important at all

Table 6.21 shows the extent of compliance to specific accounting standards. Only 25.4% say excellent and 58.8% say very good in Q20. This is also shown in Q21. Regarding the extent to which annual reports fulfil the satisfaction of users' needs, the collected answer reveals that 27.2% are very satisfied and 58.8% are satisfied. Furthermore, the majority of participants recommended dealing with Islamic banks and they are able to advise their friends and relatives to deal with Islamic banks. In this respect, 72.8% are very sure about making recommendations and 19.3% claim they will do so.

6.7 Summary

As mentioned earlier, this study is an exploratory study. It is an attempt to explore the usefulness of applying accounting standards issued by an independent organisation which takes the *Sharia'h* law as the base used in formulating its standards. The above data analysis reflects the customers' impression toward the usefulness of annual reports of Islamic banks in Bahrain after applying alternative accounting standards (AAOIFI standards).

It is clear that the participants are satisfied with Islamic banking and they opt to deal with Islamic banks because they believe that these banks can take them away from unlawful financial actions. Satisfaction has been obtained through the existence of the *Sharia'h* board in each bank. This has the authority to supervise and direct the funds of Islamic banks to lawful services and transactions. However, regulating and appointing such a board needs a qualified organisation that has familiarity with Islamic culture and requirements. Following *Sharia'h* precepts serve the society in which these banks operate. The primary objective of establishing AAOIFI is to issue standards to regulate the all areas of Islamic banking. Calculating, collecting and disbursing of the *Zakat* fund is one of the banks responsibilities on behalf of their customers. This encourages clients to motivate others to deal with such banks.

Chapter Seven

Summary and Recommendation

7. Introduction

The previous chapter analysed results of the content analysis gathered from annual reports of certain Islamic banks operating in the State of Bahrain and the questionnaire survey was gathered from the users of such reports (internal and external) who have had relationship with these Islamic banks. This chapter aims to provide a summary of the main conclusions based on the research undertaken from the literature and search through data collected from Islamic banks in Bahrain and their customers. In addition to the summary of the major findings which this research uncover the chapter provides recommendations based on these findings and a suggestion for future study in this area.

7.1 Summary of the thesis

This study was designed to investigate and explore the impact of AAOIFI standards on the financial reports of Islamic banks in the state of Bahrain. A comprehensive analysis of the financial reports of 4 Islamic banks and their users' opinion was conducted. This included the users' awareness of the relevant instruments used in preparing such statements and the usefulness of those statements in decision-making. Moreover, the users' satisfaction with the information contained within the annual reports was also examined.

Chapter Two discussed the rationale behind selecting Bahrain for the research study. The primary investigation demonstrated that two thirds of Islamic banks operating in the Gulf region were in Bahrain. Moreover, the implementation of

AAOIFI standards has been compulsory in this country since 1999. A profile of the economic development and banking in Bahrain was also presented in this chapter.

Chapter Three discussed the evolution of Islamic banking and the differences and similarities between Islamic banks and their counterpart conventional banks, the financial reports of Islamic banks and the salient features of these reports. This chapter further presented Islamic accounting information through discussing the framework and objectives of Islamic accounting and argued the need for alternative accounting standards to fill the gap in this area. *Zakat,* for example, was seen to be basis from which alternative accounting standards pertaining to Islamic banking should be considered. This chapter also discussed the reasons behind the unsuitability of Western accounting standards for the Islamic norm.

Chapter Four presented the Accounting and Auditing Organisation for Islamic Financial Institution (AAOIFI) as an independent body to set, regulate, and supervise the alternative accounting and auditing standards which fulfil the Islamic banks' objectives and fit with Islamic *Sharia'h* law. A comparison between AAOIFI standards and its counterpart IAS was undertaken as well. This chapter also presented the published AAOIFI's standards in detail for the year 2002.

Chapter Five explained the research methodology. This chapter focused on the methods that has been used in previous and similar studies and justified the choice of the methods employed in this research. The advantages of each method used in this research were also discussed. The construction of the methods used (content analysis and questionnaire) was discussed. A pilot study, its distribution and collection data procedure were also discussed.

Chapter Six dealt with matters relating to the research methodology which have highlighted the objectives of the research. The chapter discussed the sampling and structure of statistical tests. Data analysis through displaying the results by using content analysis to analyse the annual reports of some Islamic banks operating in Bahrain with early application of the AAOIFI standards was also presented. This was followed by displaying the results of the questionnaires. The chapter demonstrated how each method fulfilled the study objectives.

7.2 Summary of the findings

Inappropriate accounting standards may provide inadequate information which may drive dysfunctional behaviour. The differences between accounting standards (and in many cases, the lack of accounting standards) lead to suboptimal investment decisions, inefficient capital markets and lower social welfare than could theoretically be achieved. The absence of accounting standards, further, prevents comparability of financial information between published statements by business enterprises.

Traditional accounting postulates and principles are largely accepted and more usable in the environment where they are published. However, some of these postulates and principles do not comply with accounting ideals; they are subject to considerable debate and criticism, even from a conventional point of view. Furthermore, these postulates require the continuous examination of the current practice and as such would be a stimulus to change, reflecting the 'economic truth'. International Accounting Standards (IAS) based on such techniques would create difficulties for Muslims around the world. In addition, some of these postulates and principles are inconsistent with Islamic *Sharia'h* law.

Studies were conducted in 1987 by consulting firms and specialised experts. These studies took three years to complete and included several *Sharia'h* and accounting scholars, officials from Islamic banks, representatives of regulatory agencies, certified public accountants and other parties interested in this field of Islamic banking (AAOIFI 2002). These studies recommended and emphasised that the objectives, concepts, and standards of financial accounting must be in full compliance with the Islamic *Sharia'h*. The studies also revealed the lack of approved standards to be followed by Islamic banks in particular has a negative effect on the confidence of the users of their financial statements and the information contained therein. This reflected in a negative attitude towards dealing with Islamic banks and hesitation in investing, depositing, and exchanging services with them

The limitation of conventional accounting for the Islamic business organization can be grouped into three categories; (i) contradictory to Islamic teachings, (ii) irrelevant to Islamic accounting objectives, and (iii) insufficiency in focusing on Islamic socio-economic objectives. However, as discussed previously in chapter three, Islamic banks have specific construction characteristics which differ from traditional banks. For instance, *Sharia'h* Supervisory Board (SSB), the follow-up department, the social department, the legal department and other organisational structure. Moreover, Islamic banks cannot hold any investment income which is not in compliance with the principles of *Sharia'h* such as paying or charging interest, financing any enterprises involved in unlawful activities (gambling alcohol, pornography, etc). In addition, differences exist in the method used by Islamic banks in calculating and determining some services produced by Islamic banks such as *Musharaka*, *Zakat* etc. These differences would not enable users of financial statements to compare the various results of Islamic banks in a manner that help them in making right decisions. Moreover, Islamic banks including their annual reports with additional reports and statements, for example, SSB report, *Zakat* statement *Alqard* statement, etc, which need to seek for a specific body that is qualified to regulate such items.

Consequently, the foundation a specific organisation which aimed to develop accounting thought in the field of Islamic banking, preparing, issuing, and amending accounting standards for such banks was inevitable. This organisation supports the substantial community of accounting practitioners and scholars.

Islamic banking practitioners need to be involved in setting Islamic accounting standards. Conceivably, an appropriately advised standard-setting body could serve the need of Islamic financial organisations, bearing in mind the historic cultural and social tradition of the society. It is hoped that the body would address auditing as well as accounting problems.

Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) standards are based on these broad principles of financial reporting in their "Framework for the Preparation and Presentation of Financial Statements". One of the AAOIFI broadening objectives is to prepare, promulgate and interpret accounting and auditing standards for Islamic financial institutions in order to harmonise the accounting practices adopted by these institutions in the preparation of their financial statements, as well as harmonize the auditing procedures adopted in auditing the financial statements prepared by Islamic financial institutions. AAOIFI further adds a new objective of financial reporting, this is: to provide information to assist the concerned party in determination of *Zakat* on the Islamic bank's funds and the purpose for which will be disbursed.

However, the broad acceptance for AAOIFI's standards will tend to challenge the call for worldwide adherence to IASs to achieve international harmonisation in financial reporting regardless of cultural and religious differences. They also raise the issue of what collaborative relationship could productively be established between specialised regulatory bodies such as AAOIFI and general purpose regulatory bodies such as the IASC, IOSCO, and the Basle Committee on Banking Supervision. Accordingly, there seem to be several factors that have contributed to the low implementation of AAOIFI's standards in the countries in which Islamic banks operate. These include, among others, the lack of appreciation by the relevant agencies such as local authorities (central bank or other financial authority) that are responsible for governance and enforce accounting standards and the benefits that can be gained by implementing AAOIFI's standards, namely (a) rendering the financial statements of Islamic banks to contain relevant information which assist in decision-making; and (b) providing relevant and reliable information to users of financial statements of Islamic banks about SSB report, calculating and disbursing *Zakat* funds, and sources and usage of *Alqard* funds. This would require AAOIFI to exert more effort to have its standards recognized by holding conferences in different countries; encouraging local authorities in which Islamic banks operate to enhance these banks to apply AAOIFI standards. These results were supported by the results of this study as discussed in the following section.

7.3 Summary of the findings of content analysis

This study applies an Islamic perspective to investigate the usefulness of implementing AAOIFI standards in preparing financial statements of Islamic banks, and to discover the importance of basic and additional information contained the annual reports after applying AAOIFI standards in decision-making. Therefore, the first step was analysing the annual reports of Islamic banks who endeavour to implement AAOIFI accounting standards when they prepare their financial statements instead of using any of other accounting standards under whatever title. The analysis revealed the existent of the implementation of the AAOIFI standards in the sample that has been chosen for the investigation. On the other hand, the content analysis revealed some additional information contained the annual reports such as; the existence of SSB report; the existence of *Zakat* statement; and the existence of *Alqard* statements. However, the empirical findings demonstrate that the implementation of alternative accounting standards is not completely adhered to by most of the banks in the sample which means a shortfall in applying the AAOIFI standards. The following points summarise these findings:

1- According to the Audit Report, the disclosure witnessed a progress in 2002 compared with 1997 in general. The sole notice might be recorded on this report indicates that the First Islamic Bank did not refer to the accounting standards used.

2- All the banks in the sample have published the report of the *Sharia'h* Supervisory Board, reflecting the importance of the report for Islamic banks to provide the necessary assurance for the users of financial statements that the banks adhered by Islamic principles. However, banks may consider that the version of the report is sufficient for the users, avoiding the need for detailed disclosure. For example, the *ex-ante* auditing of transactions by the *Sharia'h* Supervisory Board (SSB) should prevent Islamic banks from engaging in unlawful transactions, so there should be nothing to disclose. *Ex-post* auditing would provide the necessary assurance for the users that Islamic principles had been followed. In addition, providing additional disclosure of matters such as the bank's activities and method of calculating *Zakat* became less important. Moreover, the SSB report disclosed the transactions that are unlawful from an Islamic perspective.

3- Regarding the accounting policy, there are some observations as follows:

i. It can be seen that, in 2002 annual reports, all banks in the sample have prepared their financial statements in accordance with the financial accounting standards issued by AAOIFI. The only exception is the ABC Islamic Bank which prepared its financial statements in accordance with AAOIFI standards and IAS. This result contradicts the results from analysing the 1997 annual reports.

ii. In spite of applying AAOIFI standards form, the analysis demonstrated that the banks were still using the method of historical cost or market value, whichever is lower, in evaluating their assets instead of using fair value. This may be attributed to the basic conventional background of the preparers of the financial statements of Islamic banks. Also this result indicates to the lack in applying AAOIFI standards in particular.

iii. Publishing of the *Zakat* statement is required for the bank that has responsibility to calculate and distribute *Zakat*. Therefore, some banks within the sample ignore publishing this statement. Moreover, the sources and usage of the *Zakat* fund are not disclosed clearly.

iv. Although AAOIFI requires Islamic banks to provide a statement of *Alqard Alhassan* as a part of a full set of financial statements, however, two out of four Islamic banks did not publish such statements.

v. There is an ambiguity in how reserves and provisions are calculated for the impairment assets. All the annual reports did not refer to how these items were calculated.

vi. Some Islamic banks charge clients who are late in repaying their loans penalties that may take the form of interest which is strictly prohibited by Islamic teaching, however, not one declared about these matters in their annual reports.

4- According to the activities of Islamic banks, the content analysis' results show that the banking activities have been Islamised in 2002. This result has been supported by declaring the banned transactions in 2002 (declaring about profit and loss sharing by restricted percentage, and declaring about social contribution).

From the content analysis, it can be seen that there is no doubt that the implementing of the Accounting and Auditing Organisation for Islamic Financial

Institutions (AAOIFI) standards improve the performance of Islamic banks in preparing their financial statements to meet Islamic *Sharia'h* precepts. This implementation was supported by BMA, as a local authority, which obligate Islamic banks operate in Bahrain to apply AAOIFI standards. AAOIFI standards grow from the roots of Islamic culture and to meet the Islamisation of the financial sector in general, and banking sector in particular. The Islamic banks have shifted their functions and actions to fit with Islamic *Sharia'h* precepts. Although Islamic banks apply AAOIFI standards, there is a shortfall in the application. Therefore, the search and investigation for the impact of the AAOIFI standards is continued in this study to discover the usefulness of such standards in improving the quality of annual reports to assist users in decision-making, and the contribution of AAOIFI to enhance Islamic knowledge.

7.4 Summary of the findings of questionnaire

The aim behind surveying the respondents is to find out accepted answers that can meet the objectives of the study. Therefore, the study employed the questionnaire as an important instrument to achieve the task. Using a questionnaire is good for collecting certain types of information quickly, relatively cheaply and easy to manipulate numerically. In the meantime, the responses collected from the participants should reflect the mainstream of the responses towards certain issues. As explained earlier, the study divided the questionnaire into two main parts: part one deal with collecting profile data on the participants. Part two divided into four sections. This part is dedicated to achieve the objectives of the study. The following points summarised the answers to the study questions:

1- The results extracted from the first part of the questionnaires are important to build a neutral opinion about the participants and their judgement about the investigated items in this subject. The study shows that the majority of Islamic annual reports users are well educated with about 89% holding a Bachelor degree or above. The results also show that over 75% of participants are less than 45 years of age. On the other hand, the results indicate that more than 78% of financial statements' users have had previous banking experience for more than 5 years, and more than 76% have had awareness with Islamic banks in Bahrain for more than 5 years. These results serve the research in the point of targeted group and their relationship with the organisations included the sample.

2- As was expected, the results revealed that the need for regulated accounting information was endorsed by the participants. This was proved either by strongly supporting the information based on the regulated form. These sources vary from the annual reports (55.3% strongly agree and 36% agree), to direct information form banks' departments (31.6% strongly agree and 33.3% agree). However, neglecting the unregulated sources also supporting the regulated information as useful source. The respondents of questionnaires regarding the unregulated accounting information have less advantage among users of accounting information. The findings showed that the users rely less on unregulated accounting information (Q2e and Q2f). Responses vary from financial market's rumours (Q2e, 0.9% strongly agree and 14.9% agree) to advice from friends (Q2f, 6.1% strongly agree and 42.1% agree). On the other hand, both private and public sector must co-operate in regulating such information. This result is consistent with Al-Hajji (2003).

3- According to the users' perception about the applied accounting standards, the results revealed that the majority of users were aware with the accounting standards used in preparation of the financial statements of Islamic banks operating in Bahrain. Furthermore, the users had had knowledge about the existence of AAOIFI and support the organisation as an organisation qualified in setting Islamic accounting standards. However, the investigation about the importance of applying the AAOIFI standards in decision-making showed that the main factor assisting in decision-making was following *Sharia'h* precepts, while applying AAOIFI standards was in the sixth position among other factors.

4- About the items that should be included in the annual reports of Islamic banks to enhance and improve the usefulness of information contained of such reports, the results of data analysis showed that the auditors' report recorded a remarkable result in this aspect, the income statement was in the second position and SSB report was the third most useful item in assisting decision-making. The annual reports of Islamic banks disclosed additional information in their annual reports. The analysis showed that the SSB report was the most important items that should be enclosed, *Zakat* statement second, calculating provision and reserves third, while *Alqard Alhassan* statement were fourth. However, the analysis of the results indicated that the statement of changes in unrestricted investment accounts has the lowest support among other items.

5- The results indicate that the main feature which encourages people to deal with Islamic banks is the existence of the *Sharia'h* Supervisory Board playing a crucial role in purifying the Islamic banking transactions from any prohibited transactions which is inconsistent with Islamic *Sharia'h* precepts. However, this study revealed a negative impact resulted from the name of Islamic banks as an indication for Islamisation of its production. This finding contradicts with the findings of Nasser (1999) who states that the existence of the word "Islamic" in the name of the bank encourages individuals to deal with it. Questioning about the impact resulted from applying AAOIFI to encourage individuals to deal with Islamic banks show less effect of this factor among external users (G2). While, internal groups (G1) support this factor.

7.5 Recommendations

It is believed that standard-setting should build upon what has been done elsewhere, but should also be designed to meet unique needs. The emergence of a specific accounting standard body as alternative organisation for developing professional standards became necessary and urgent at this time. The emergence of AAOIFI has been designed to confront the legal environment and ethics of taking full consideration of the experiences and practices prevailing in the developed countries. On the other hand, the establishment of an independent organisation to set Islamic accounting standards is necessary for Islamic financial institutions in general and Islamic banks in particular to fill the existing gap in this area. Accordingly, it may be better to support the AAOIFI organisation to fulfil its objectives. Furthermore, it can be recommended that:

1. According to the customers' profile, the result reveals the Islamic banks customers and employees are relatively young and are highly educated. These findings can be used as a base for improving the output of Islamic banking which fulfils their needs.

2. The focus should be on developing *Sharia'h* Supervisory Boards and their action in providing adequate advice and presenting SSB reports which serve users in decision-making and assure them about the purification of Islamic banking from prohibitive transactions. It is may be better if the SSB report can be enhanced by paying closer attention to details.

3. The main objective of SSB is to ensure that only Islamically permitted economic activities are carried out by Islamic banks and ensure the quest for profits by Islamic banks does not infringe society's rights. Therefore, the SSB reports should contains *ex-ante* audits to prevent any Islamic banks falling into unlawful contracts or funding transactions which contradict *Sharia'h* law.

4. The accounting information should provide information on *Sharia'h* compliance, report prohibition transactions, the disposal of income gained from such transactions and acting the ex-auditing contracts by *Sharia'h* Board members. This can be achieved by specifying clearly the role of SSB report in disclosing and determining the activities that should be practiced by Islamic banks.

5. The AAOFI has no power to enforce its standards. The best way for implementing AAOIFI standards in the various Muslims countries is depending on: the co-operation of Muslims accountant's scholars; exert efforts to hold conferences about the benefits from uniforming Islamic finance and presenting the AAOIFI as the alternative organisation in this area.

6. Developing researches for Islamic accounting standards and support the researchers in this area.

7.6 Critical reflection

This study has attempted to investigate the impact of AAOIFI standards on the financial reports of Islamic banks. Bahrain was chosen for the purpose of the study because it is the first country implementing AAOIFI standards. In order to guide future researchers, critical reflections are summarised below:

1. The primary methods used were content analysis and a questionnaire. Ideally interviews would have been conducted with senior mangers to

further develop the research framework. New researcher coming to this area might like to consider this area for further development.

2. The analysis was restricted in the annual reports to a comparison of two years 1997 and 2002. As time goes on more data will inevitably become available to further develop any study of Islamic financial reporting standards and ideally more data would have improved the PhD. While the content analysis in this thesis is robust it could be further developed in future if and when more financial institutions adopted Islamic financial reporting standards.

3. A further fascinating area of work suggested by study as yet an explored is the composition and function of Sharia'h board and specifically the way they undertake their activities. A comparison in this area would add significantly to knowledge and a measure of their impact on financial reporting would have improved the analysis.

4. Finally, a comparative study in this area between countries adopting AAOIFI seems to this researcher to have considerable potential but was not possible in the context of the research.

7.7 Future research

This study has covered partly an important area in Islamic accounting information, therefore, it is suggested here that for future research, the investigation of the impact of the AAOIFI standards should cover all banks in different countries. The voluntary implementation of AAOIFI in certain countries such as Qatar, Malaysia and Sudan will help researchers to achieve their job. It is also suggested here that a study should encompass preparers of financial reports for Islamic banks on wider scale and cross nations, instead of in the limited form of one country. The impact of the *Sharia'h* Supervisory Board on the quality of the financial reporting of Islamic banks and the extent of disclosure it should contain is also worthy of study.

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Appendices

Content Analyses (work sheet)
Investigate the existence of AAOIFI accounting standards in the annual reports of Islamic banks

Part one: general information

CODE: (   )   Country:-----------------

Bank Name

Establishing date of the bank

Financial year ended: /   /   ,   /   /

	1997	2002
Number of branches		
Number of foreign branches		
Number of employees		
Number of directors		
Number of SSB members		
Total assets		
Shareholders' equity		
Net profit		
Total operating expenses		
Dividend paid		
Donation and contribution		

Part two: Information related to the Auditor Report

Name of the auditor…………………………………………………

Is the auditor?

Government Agency		Affiliated to Big firm	
Local company		Solely international	

To whom the audit report is addressed?

	1997	2002
Board of directors		
Management		
Shareholders		
Other		

Non		

How many paragraphs the audit report contains?

	1997	2002
Three		
Four		
Five		
Other		

Is it referring to the auditing standard conducted there in?

	1997	2002
Yes		
No		

Is it referring to accounting standard adopted by the bank concern?

	1997	2002
Yes		
No		

If yes, which of the following accounting standard?

	1997	2002
AAOIFI		
IASB		
Local Accounting standard		
Other		

Is the auditor report signed?

	1997	2002
Yes		
No		

Is the auditor report dated?

	1997	2002
Yes		
No		

Part three: Information related to the Sharia'h Supervisory Report (SSB)

Is the annual report containing Sharia'h Supervisory Report (SSB)?
(If no go to part four)

	1997	2002
Yes		
No		

Is the annual report declared that the SSB entrusted to ensure the bank's adherence to sharia'h rules?

	1997	2002
Yes		
No		

To whom the report is directed?

	1997	2002
Board of directors		
Management		
Shareholders		
Other		
Non		

How many paragraphs it contains?

	1997	2002
Three		
Four		
Five		
Other		

Is the SSB report referring to the accounting standard adopted by the bank?

	1997	2002
Yes		
No		

If yes, which of the following accounting standards?

	1997	2002
AAOIFI		
IASB		
Local Accounting standard		
Other		

Is the Sharia'h Supervisory Report signed?

	1997	2002
Yes		
No		

Is the Sharia'h Supervisory Report dated?

	1997	2002
Yes		

No		

Have the Sharia'h Supervisory Report raised any concern about the activities of the bank in their report

	1997	2002
Yes		
No		

Is the SSB report declare that the realised income from sources prohibited by Islamic sharia'h have been disposed of to charitable causes

	1997	2002
Yes		
No		

Part four: Information related to the accounting policy

	1997	2002
The bank was established as Islamic bank		
The bank convert its activity from traditional bank		
The financial statements has been prepared in accordance with AAOIFI standards		
Classification of assets and liabilities into current and non current		
The financial statements are prepared under modified historical cost		
Balances related to financial contracts* are stated net of provisions for impairment and deferred profit		
Available for sale are re-measured at fair value		
Investment in properties are stated at fair value		
Unrestricted investment accounts are carried at cost less repaid amount		
Referring to method of calculating depreciation in index note		
Profit and loss from financial contracts are recognised upon liquidation of each transaction		
The bank calculating reserves and provisions for impairment assets		
The calculation of impairment provisions are based on the assessment of the bank		
Referring to how computing Zakat		
Equity of unrestricted and restricted investment accounts recognised when received by the bank		
Equity of unrestricted and restricted investment accounts measured by the amount received by the bank		

All of non-Islamic income is credited to charity funds		
Disclose the percentage for profit allocation between owners and various unrestricted investment account holders.		
Disclose the allocation of profit between owners and restricted investment account holders		
At the end of a financial period, equity of unrestricted and restricted accounts measured at their book value.		
Disclose the bank's responsibility toward the social where it operates		
Statement of Changes in the Owners' Equity		
The existence of the statement in the annual report		
Referring to the Zakat and charity in the statement		
Zakat and Charity Statement		
The existence of the Zakat and Charity statement in the annual report		
Calculating Zakat before net profit for the year		
Referring to how calculate Zakat		
Disclose the sources of money		
Disclose the uses of money		
The ratio for Zakat is 2.5775 % for a solar calendar year		
Treating Zakat as a non income expenses		
Unpaid Zakat treated as a liability		
Chas Flow Statement		
Existence of cash flow statement		
Classifying the cash flow into: cash flow from investing activities, and cash flow from financing activities		
Referring to the changes in investment activities		
Referring to the changes in financing activities		
Al-Qard Al-Hassan statement (social contribution)		
Existence of Qard Al-Hassan statement		
Disclose the sources of money		
Disclose the uses of money		
Classifying the statement into sources and uses of funds		

* Financial contracts consist of Mudarabah receivable, Mudarabah financing, Musharakah financing.

AAOIFI accounting standard indication	1997	2002
Positive		
Negative		
Ratio	%	%

Part five: Information related to the bank activities and operations

	1997	2002
Focusing on Islamic productions compared with total assets:		
➢ Murabaha financing		
➢ Mudarabah financing		
➢ Musharakah financing		
➢ Investment in leasing		
➢ Salam and parallel Salam financing		
➢ Investment in Istisna'a		
➢ Investment in Ijara assets		
➢ Ijara Muntahia Bittamleek		
➢ Investment in properties		
Focusing on Income from Islamic production compared with total income		
➢ Income from Murabaha financing		
➢ Income from Mudarabah financing		
➢ Income from Musharakah financing		
➢ Income from Investment in leasing		
➢ Income from Investment in Istisna'a		
➢ Income from Investment in Ijara assets		
➢ Income from Ijara Muntahia Bittamleek		
➢ Income from Investment in properties		

Questionnaire

To appraise the effecting of AAOIFI Standards on the quality of the financial statements of Islamic Banks

To Whom It May Concern:

Major development and rapid expansion have emerged in the Islamic financial institutions in the recent years, creating tremendous investments and public interest in the function of these organisations. This requires proper uniform accounting system based on unique standards raised from *Sharia'h* Islamia'h to regulate its operations. I would like to inform you that I am currently PhD student at Glamorgan University. UK, undertaking a research project entitled "the Impact of AAOIFI Standards on the Financial Reporting of Islamic Banks".

As regard you are one of the Islamic financial institution's customer, the researcher sent you this questionnaire. The main objective of this questionnaire is to obtain your opinion toward the adequacy of information content, use, and usefulness of annual report of Islamic institutions in your decision-making. You are among those who have been chosen randomly in the group of Islamic organisation's customers. To ensure the survey represents all types of people. I would be extremely grateful if you kindly spare a few moments of your time to answer all the questions carefully and write any comments and suggestions you may think are relevant on the last page. All information obtained from this questionnaire will be treated with strict confidence and will be used only for the purpose of research. If you have any queries about the questionnaire please e-mail it at ***mabuhmai@glam.ac.uk***

Name of Researcher:

Mustafa A. Abuhmaira

University of Glamorgan, UK

Instruction:

Please answer all questions (except those are not applicable to you) by ticking on the box of your choice, and give answer without reference to other person. Please feel free to give any suggestion or comment at the end of the questionnaire, or e-mail it to: mabuhmai@glam.ac.uk

Part one: General information:

1. Gender

- Male ☐
- Female ☐

2. Age

- less than 25 years ☐
- 25 – 35 ☐
- 35 – 45 ☐
- More than 45 ☐

3. Education

- Secondary or less ☐
- Bachelor ☐
- Master ☐
- Doctoral ☐

4. Experience

- Less than 1 year ☐
- +1 - 5 ☐
- 6 - 10 ☐
- Above 10 ☐

5. Profession

- Accountant ☐
- Financial Analysts ☐
- Academics ☐
- Institutional investors ☐
- government representative ☐
- Stock market representative ☐
- Bank Credit Officer ☐
- Other ☐

6. How long have you heard about Islamic bank? (   )

7. How long did you start to deal with Islamic bank? (   )

8. What kind of relationship tied you with Islamic bank? Is it because;

- You have current account ☐
- You have saving account ☐
- You have investment account ☐
- You have shares ☐
- You are employed by the bank ☐
- You have another transaction ☐
- Other, please specify ………………………………………………..

Part two: About perception of AAOIFI standards

1. Why you are interested in the information published by Islamic bank? Is it because you are;

Investor ☐

Financial Analyst ☐

Banker ☐

Government employer ☐

Government agency, stock market ☐

2.In making transactions with Islamic bank, how do you rate the following information sources?

(1.Strongly agree, 2. agree, 3. indifferent, 4. disagree, 5. strongly disagree). In column 6, please rank the importance of the resources, No 1 is best.

	1	2	3	4	5
Bank annual reports					
Bank interim reports (quarter annual report)					
Direct information from bank					
Newspaper and business magazines					
Government publications and statistics					
Market's rumours					
Friends advice					
Specialised publications (e.g. stock exchange market report& chamber of commerce report)					
Other sources, please specify					

3.Do you think that the accounting information for Islamic banks should be regulated?

Yes ☐ No ☐

4.If you answered "Yes" to the above question, please indicate your opinion on accounting standards in Islamic banks from the options below:

	1	2	3	4	5
Accounting standards should be set by the public sector					
Accounting standards should be set by private sector					
Accounting standards should be set by public & private sector					
Other, Please specify					

5.Have you got any idea about the Accounting and Auditing Organisation for Islamic Financial Institution (AAOIFI)?

Yes ☐ No ☐

6.Do you think that the AAOIFI is qualified to establish accounting standards?

Yes ☐ No ☐

7.Have you got any idea about the applicable accounting standards in the bank you deal with?

Yes(answer ques. 8) ☐ No (answer ques. 9) ☐

8.If yes, which accounting standards dose your bank apply?

	1	2	3	4	5
International Accounting Standards Board (IASB)					
Accounting and Auditing Organisation for Islamic Financial Institution (AAOIFI)					
Local Accounting Standards Board					

9.If no, which of the following accounting organisation do you think should regulate the accounting information?

	1	2	3	4	5
International Accounting Standards Board (IASB)					
Accounting and Auditing Organisation for Islamic Financial Institution (AAOIFI)					
Local Accounting Standards Board					

10. Which of the following aspects should be considered when dealing with the Islamic banks?

	1	2	3	4	5
Reputation of Islamic bank					
Application of AAOIFI standards					
Its name contains an "Islamic" word					
Performing high ratio of profit					
Producing only Islamic productions					
Other, Please specify..					

11. What are the main factors motivating the customers to deal with Islamic banks?

	1	2	3	4	5
Following *Sharia'h* precepts					
Its name contains an "Islamic" word					
Application of AAOIFI standards					
Reputation of Islamic bank					
Performing high ratio of profit					
Existing in different areas (many branches)					
Periodic distribution of profits					
Service quality					
Other, Please specify...					

12. Which of the following items in the financial reports of Islamic bank is very useful when making decisions?

	1	2	3	4	5
Chairman's report					
Sharia'h Supervisory Board's report					
Auditor report					
Board of director report					
Balance Sheet					
Income Statement					
Statement of Changes in Shareholders' Equity					
Statement of cash flows					
Zakat statement					
Al-Qard AL-Hassan statement					
Statement of changes in unrestricted investment					
Other, Please specify...					

13. Please rate the degree of the following qualitative characteristics of the financial information contained in annual reports of Islamic banks;

	1	2	3	4	5
Simplicity of the presentation					
Timeless of the information					
Neutrality of the information					
Credibility of the information					
Comparability of the information					
Easy to collect the information					
Confirmed from an independent agency					
Other, please specify					

14. Does the time lag between the closing date of the accounting period and the publishing of the statements affect decisions-making?

Yes ☐ No ☐

15. Please state the level of importance of the following items contained within the annual report

(1. Very important, 2.important, 3.indifferent, 4.less important, 5. not important). At column 6, please rank the importance of the resources, No 1 is the best.

	1	2	3	4	5
The importance of calculating provision and reserves on the impairment assets					
Referring to the method of calculating provisions					
Referring to the treatment of impairment assets					
Referring to the amount of impairment assets					
The level of disclosure about the provisions					

16. Please state the importance of the following information in the *Sharia'h* Supervisory Board report (SSB)

	1	2	3	4	5
The importance of the report					
Referring to *ex ante* auditing the contracts					
Referring to the treatment of insolvencies clients					
Referring to sources of non-Islamic income					
The level of disclosure in the SSB report					

17. Please state the importance of the following information about *Zakat* statement

	1	2	3	4	5
The importance of the statement					
Referring to how *Zakat* is calculated					
Referring to the sources of funds					
Referring to the uses of funds					
The level of disclosure					

18. Please state the importance of the following information about *Al-Qard Al-Hassan* statement

	1	2	3	4	5
The importance of the statement					
Referring to the sources of funds					
Referring to the uses of funds					
The level of disclosure					

19. In general, do you think that the following parts of the annual report have sufficient disclosure?

(1.Strongly agree, 2. agree, 3. indifferent, 4. disagree, 5. strongly disagree). In column 6, please rank the importance of the resources, No 1 is best.

	1	2	3	4	5
Chairman's report					
Sharia'h Supervisory Board's report					

Auditor report					
Balance Sheet					
Income Statement					
Statement of Changes in Shareholders' Equity					
Statement of cash flows					
Zakat statement					
Al-Qard AL-Hassan statement					
Notes to the financial statements					

20. To what extent do you think that the bank abide by the used accounting standards?

Excellent	**Very good**	**satisfactory**	**bad**	**Very bad**
☐	☐	☐	☐	☐

21. To what extent do you think that the annual report fulfil the dealers' needs

Very satisfied	**Satisfied**	**satisfactory**	**Unsatisfied**	**very unsatisfied**
☐	☐	☐	☐	☐

22. How likely are you to recommend relatives and friends to deal with Islamic banks

Strongly recommend	**recommend**	**No opinion**	**Recommend against**	**Strongly recommend against**
☐	☐	☐	☐	☐

23. Thank you for completing this questionnaire. If you have any comments, please state them here.

إستبيان

حول تأثير معايير هيئة المحاسبة والمراجعة للمؤسسات الإسلامية

(AAOIFI) على جودة التقارير المالية للمصارف الإسلامية

عزيزي المشارك في الاستبيان

لقد شمل التطور جميع مجالات الحياة بما في ذلك المصارف الإسلامية التي تعد إحدى أدوات التنمية الاقتصادية في المجتمعات التي تعمل فيها. ويعتمد نجاح تلك المصارف إلى حد كبير على توفر المعلومات المالية وغير المالية لمن لهم علاقة بها إستثمارا أو تمويلا أو تنظيما، وهذا يتطلب إيجاد نظام محاسبي موحد مبني على أسس موحدة أساسها الشريعة الإسلامية لقياس آداء تلك المؤسسات.

أفيدك عزيزي المشارك بأنني أقوم في الوقت الحاضر بإجراء بحث لنيل درجة الدكتوراة عن تأثير معايير المحاسبة الصادرة عن هيئة المحاسبة والمراجعة للمؤسسات الإسلامية (AAOIFI) على جودة التقارير المالية من حيث توفر المعلومات التي تسهم في صنع القرار.

باعتبارك أحد المتعاملين مع المصرف، فقد تم اختيارك بطريقة جزافية للمساهمة في إثراء هذا البحث. إن الهدف الرئيسي لهذا البحث هو الوصول إلى تكوين رأي عام من خلال سبر آراء مختلف شرائح المجتمع حول موضوعية تلك المعايير وتأثيرها على جودة المعلومات المنشورة.

مع تقديمي الشكرالجزيل لكم سلفا، فإنني أؤكد لكم أن الإجابات سوف تستخدم لغرض البحث الأكاديمي فقط، ولن يطلع أحد عليها.

..... وتقبلوا فائق الإحترام والتقدير.

الباحث

مصطفى على أبوحميرة

مرشح للدكتوراة في جامعة جلامورجان ـ كاردف. بريطانيا.

إرشادات حول ملء الاستبيان:

لقد روعي عند إعداد هذا الإستبيان ألا يأخذ من وقتك وجهدك إلا القليل. مع تقديري التام لمشاركتك في هذا البحث، أرجو التفضل بوضع علامة(✓) أمام الاجابة المناسبة.

إذا كانت لديك أية استفسارات أو تعليقات يمكنك توضيحها في آخر الإستبيان أوإرسالها عبر البريد الالكترونيعلى العنوان التالي: (mabuhmai@glam.ac.uk)

القسم الأول: معلومات عامة

1- الجنس

- ذكر ☐
- أنثى ☐

2- العمر

- أقل من 25 سنة ☐
- + 25 – 35 ☐
- + 35 – 45 ☐
- أكثر من 45 سنة ☐

3- المستوى التعليمي

- متوسط فأقل ☐
- جامعي ☐
- ماجستير ☐
- دكتوراة ☐

4- الخبرة العملية

- أقل من سنة ☐
- +1- 5 ☐
- +5- 10 ☐
- أكثر من 10 سنوات ☐

5- التخصص

- محاسب ☐
- محلل مالي ☐
- أكاديمي ☐
- مستثمر ☐
- موظف دولة ☐
- موظف بالسوق المالي ☐
- مقرضي المصرف ☐
- فئات أخرى ☐

6- ما هى مدة معرفتك بالمصارف الإسلامية ؟ (   )

7- ما هي مدة تعاملك مع المصارف الإسلامية ؟ (   )

8- ما نوع العلاقة التى تربطك بالمصرف ؟

- لديك حساب جاري ☐
- لديك حساب إستثمار ☐
- لديك تعاملات تجارية مع المصرف ☐
- لديك حساب إدخار ☐
- لديك أسهم ملكية في المصرف ☐
- موظف بالمصرف ☐
- علاقة أخرى، يرجى التحديد..

القسم الثاني : حول الدراية والمعرفة بمعايير المحاسبة المستخدمة:

1- ما هي العلاقة التي تجعلك تهتم بالمصارف الإسلامية ومن ثم تتخذ قرارا بشأنها؟ هل لأنك :

- مستثمر خاص ؟ ☐
- محلل أو مستشار مالي ؟ ☐
- موظف مصرفي ؟ ☐
- موظف حكومي؟ ☐
- مسؤول فى أحد صناديق الإستثمار أو في السوق المالي؟ ☐
- علاقة أخرى، يرجى التوضيح...

2- عند تعاملك مع المصرف فإن مصادرالمعلومات الأكثر أهمية هي:

[أرجو منك تقدير أهمية تلك المصادر بوضع علامة في المربع المناسب . في العمود الأخير، يرجى ترتيب تلك المصادر من الأكثر أهمية إلى الأقل بحيث يمثل 1 أكثرها أهمية.]

	موافق بقوة	*موافق*	*محايد*	*غير موافق*	*غير موافق بقوة*
التقرير السنوي للمصرف	☐	☐	☐	☐	☐
التقرير الموقت خلال السنة (التقرير ربع السنوي مثلا)	☐	☐	☐	☐	☐
المعلومات المباشرة من إدارة المصرف	☐	☐	☐	☐	☐
الجرائد والمجلات المتخصصة	☐	☐	☐	☐	☐
الإشاعات المتداولة في السوق	☐	☐	☐	☐	☐
نصائح الأصدقاء	☐	☐	☐	☐	☐
القنوات المتخصصة (السوق المالي مثلا)	☐	☐	☐	☐	☐

أخرى، يرجى التوضيح...

3- هل تعتقد أنه من الضروري تنظيم المعلومات المحاسبية؟

نعم ☐ لا ☐

4- إذا كانت الإجابة بنعم في السؤال السابق، فيما يلي بعض الجهات التي يفترض أن تسهم في صياغة المعايير المستخدمة في تنظيم تلك المعلومات. ما هو رأيك حولها؟

	موافق بقوة	*موافق*	*محايد*	*غير موافق*	*غير موافق بقوة*
معايير المحاسبة يجب أن تنظم من قبل القطاع العام (الحكومة)	☐	☐	☐	☐	☐
معايير المحاسبة يجب أن تنظم من قبل القطاع الخاص	☐	☐	☐	☐	☐
معايير المحاسبة يجب أن تنظم من قبل القطاع العام والخاص	☐	☐	☐	☐	☐

من قبل جهات أخرى، يرجىالتحديد...

5- هل لديك فكرة عن هيئة المحاسبة والمراجعة للمؤسسات المالية الإسلامية (AAOIFI)؟

نعم ☐ لا ☐

6- هل ترى أن هيئة المحاسبة والمراجعة مؤهلة لإصدار معايير محاسبية لتنظيم المعلومات المحاسبية؟

نعم ☐ لا ☐

7- هل لديك فكرة عن معايير المحاسبة المستخدمة في المصرف الذي تتعامل معه أو تشتغل فيه؟

نعم (أجب على السؤال الثامن) ☐ لا (أجب على السؤال التاسع) ☐

8- إذا كانت الإجابة بنعم في السؤال السابق، هل هذه المعايير هي:

[أرجو منك تقدير أهمية تلك المصادر بوضع علامة في المربع المناسب . في العمود الأخير، يرجى ترتيب تلك المعايير من الأكثر أهمية إلى الأقل بحيث يمثل رقم 1 أكثرها أهمية.]

	موافق بقوة	*موافق*	*محايد*	*غير موافق*	*غير موافق بقوة*
معايير المحاسبة الدولية (IAS)	☐	☐	☐	☐	☐
معايير هيئة المحاسبة والمراجعة (AAOIFI)	☐	☐	☐	☐	☐
معايير المحاسبة المستخدمة محليا	☐	☐	☐	☐	☐

أخرى، يرجى التحديد ....

9- إذا لم يكن لديك معلومة حول المعايير المستخدمة في المصرف . أي المعايير التالية تراها أنسب لتنظيم المعلومات المحاسبية في المصرف؟

	موافق بقوة	*موافق*	*محايد*	*غير موافق*	*غير موافق بقوة*
معايير المحاسبة الدولية (IAS)	☐	☐	☐	☐	☐
معايير هيئة المحاسبة و المراجعة (AAOIFI)	☐	☐	☐	☐	☐
معايير المحاسبة المستخدمة محلي	☐	☐	☐	☐	☐

أخرى، يرجى التحديد ....

10- ما هي في رأيك أهم الجوانب التي يجب أن تؤخذ بعين الإعتبار عند التعامل مع المصرف؟ هل هي:

	موافق بقوة	*موافق*	*محايد*	*غير موافق*	*غير موافق بقوة*
سمعة المصرف؟	☐	☐	☐	☐	☐
تطبيقه لمعايير المحاسبة الإسلامية **(AAOIFI)** ؟	☐	☐	☐	☐	☐
كون إسمه يحتوي على كلمة " إسلامي"؟	☐	☐	☐	☐	☐
تحقيقه لأعلى مستوى أرباح؟	☐	☐	☐	☐	☐
كونه يقدم الخدمات التي تتفق مع تعاليم الشريعة فقط؟	☐	☐	☐	☐	☐
لديك أسهم ملكية فيه؟	☐	☐	☐	☐	☐

أخرى، يرجى التحديد ....

11- ما هي في رأيك أهم العوامل التي تشجع الزبائن على التعامل مع المصرف؟ هل هي:

	موافق بقوة	*موافق*	*محايد*	*غير موافق*	*غير موافق بقوة*
إتباعه لتعاليم الشريعة الإسلامية؟	☐	☐	☐	☐	☐
كون إسم المصرف يحتوي على كلمة " إسلامي"؟	☐	☐	☐	☐	☐
تطبيقه لمعايير المحاسبة الإسلامية (AAOIFI)؟	☐	☐	☐	☐	☐
سمعة المصرف في السوق؟	☐	☐	☐	☐	☐
تحقيقه لمعدلات عالية للأرباح؟	☐	☐	☐	☐	☐
تواجد المصرف في مناطق مختلفة (كثرة الفروع)؟	☐	☐	☐	☐	☐
توزيعه المنتظم للأرباح؟	☐	☐	☐	☐	☐

جودة الخدمات المقدمة ؟	☐	☐	☐	☐	☐

أخرى، يرجى التحديد ....

12- حسب ما ترى. أي التقاريرالتالية أكثر أهمية من حيث كونه مصدرا للمعلومات المستخدمة في صنع القرار؟

	موافق بقوة	*موافق*	*محايد*	*غير موافق*	*غير موافق بقوة*
تقرير رئيس مجلس الإدارة	☐	☐	☐	☐	☐
تقرير هيئة الرقابة الشرعية	☐	☐	☐	☐	☐
تقرير مدققي الحسابات	☐	☐	☐	☐	☐
تقرير الإدارة	☐	☐	☐	☐	☐
الميزانية العمومية	☐	☐	☐	☐	☐
حساب الأرباح والخسائ	☐	☐	☐	☐	☐
قائمة التغير في حقوق الملكية	☐	☐	☐	☐	☐
قائمة التدفق النقدي	☐	☐	☐	☐	☐
قائمة مصادر وإستخدامات أموال الزكاة	☐	☐	☐	☐	☐
قائمة مصادر وإستخدامات أموال القرض الحسن	☐	☐	☐	☐	☐
قائمة التغير في حسابات الإستثمار المطلقة	☐	☐	☐	☐	☐

أخرى، يرجى التحديد..

13- فيما يلي مجموعة من الخصائص النوعية لمصادر المعلومات، الرجاء تقدير أهمية تلك الخصائص بحسب تأثيرها على مدى جودة ونوعية المصدر نفسه.

	موافق بقوة	*موافق*	*محايد*	*غير موافق*	*غير موافق بقوة*
بساطة وسهولة عرض المعلومات	☐	☐	☐	☐	☐
التوقيت	☐	☐	☐	☐	☐
حيادية مصدر المعلومات	☐	☐	☐	☐	☐
مصداقية مصدر المعلومات	☐	☐	☐	☐	☐
إمكانية المقارنة	☐	☐	☐	☐	☐
سهولة الحصول على المصدر	☐	☐	☐	☐	☐
تحقق جهة مستقلة من صحة المعلومة	☐	☐	☐	☐	☐

أخرى، يرجى التحديد ....

14- هل تعتقد أن التأخير في نشر التقارير المالية يؤثر في إتخاذ القرارات؟

نعم ☐ لا ☐

15- من فضلك، حدد أهمية المعلومات التالية التي يحتويها التقرير المالي السنوي ؟

[أرجو منك تقدير أهمية تلك المصادر بوضع علامة في المربع المناسب . في العمود الأخير ، يرجى ترتيب تلك المعلومات من الأكثر أهمية إلى الأقل بحيث يمثل رقم 1 أكثرها أهمية.]

	مهم جدا	مهم	قليل الأهمية	غير مهم	غير مهم على الاطلاق
إحتساب المخصصات للأصول المشكوك في تحصيلها	☐	☐	☐	☐	☐
توضيح كيفية إحتساب إحتياطيات للأصول التالفة	☐	☐	☐	☐	☐
توضيح قيمة الأصول المعدومة	☐	☐	☐	☐	☐
توضيح المعالجة المحاسبية للأصول المعدومة	☐	☐	☐	☐	☐
مستوى الإفصاح في التقرير المالي للبنود السابقة	☐	☐	☐	☐	☐

16- من فضلك، حدد أهمية المعلومات التالية في التقرير المالي فيما يتعلق بتقرير هيئة الرقابة الشرعية؟

	مهم جدا	مهم	قليل الأهمية	غير مهم	غير مهم على الاطلاق
مدى أهمية التقرير	☐	☐	☐	☐	☐
مدى شموله على المراجعة المسبقة للعمليات المحاسبية(العقود)	☐	☐	☐	☐	☐
مدى توضيحه للمعالجة المحاسبية لحالات الإفلاس	☐	☐	☐	☐	☐
مدى توضيحه لمصادر الدخل غير المشروع	☐	☐	☐	☐	☐
مدى توضيحه لإستخدامات الدخل غير المشروع	☐	☐	☐	☐	☐
مستوى الإفصاح في التقرير	☐	☐	☐	☐	☐

17- من فضلك، حدد أهمية المعلومات التالية في التقرير المالي فيما يتعلق بقائمة الزكاة ؟

	مهم جدا	مهم	قليل الأهمية	غير مهم	غير مهم على الاطلاق
إعداد قائمة الزكاة	☐	☐	☐	☐	☐
توضيح كيفية إحتساب الزكاة	☐	☐	☐	☐	☐
توضيح مصادر أموال الزكاة	☐	☐	☐	☐	☐
توضيح إستخدامات أموال الزكا	☐	☐	☐	☐	☐
مستوى الإفصاح في القائمة	☐	☐	☐	☐	☐

18- من فضلك، حدد أهمية المعلومات التالية في التقرير المالي فيما يتعلق بقائمة القرض الحسن؟

	مهم جدا	مهم	قليل الأهمية	غير مهم	غير مهم على الاطلاق
إعداد قائمة القرض الحسن	☐	☐	☐	☐	☐
توضيح مصادر أموال القرض الحسن	☐	☐	☐	☐	☐
توضيح إستخدامات أموال القرض الحسن	☐	☐	☐	☐	☐
مستوى الإقصاح في القائمة	☐	☐	☐	☐	☐

19- بشكل عام،هل تعتقد أن الأقسام التالية للتقرير السنوي للمصرف تحتوي على درجة كافية من الافصاح؟

[أرجو منك تقدير أهمية تلك المصادر بوضع علامة في المربع المناسب. في العمود الأخير، يرجى ترتيب تلك الأقسام من الأكثر إفصاحا إلى الأقل بحيث يمثل رقم 1 أكثرها أهمية.]

	موافق بقوة	*موافق*	*محايد*	*غير موافق*	*غير موافق بقوة*
تقرير مجلس الإدارة	☐	☐	☐	☐	☐
تقرير هيئة الرقابة الشرعية	☐	☐	☐	☐	☐
تقرير المحاسب القانوني	☐	☐	☐	☐	☐
قائمة المركز المالي	☐	☐	☐	☐	☐
حساب الأرباح والخسائر	☐	☐	☐	☐	☐
قائمة التغير في حقوق الملكية	☐	☐	☐	☐	☐
قائمة التدفقات النقدية	☐	☐	☐	☐	☐
قائمة الزكاة	☐	☐	☐	☐	☐
قائمة القرض الحس	☐	☐	☐	☐	☐
الإيضاحات حول القوائم المالية	☐	☐	☐	☐	☐

20- بشكل عام، ما مدى تقديرك لدرجة التزام المصرف بمعايير المحاسبة المستخدمة؟

ممتاز	جيد جدا	مقبول	ضعيف	ضعيف جدا
☐	☐	☐	☐	☐

21- الى أي مدى ترى أن التقرير المالي للمصرف يلبي إحتياجات المتعاملين؟

	موافق بقوة	*موافق*	*محايد*	*غير موافق*	*غير موافق بقوة*
درجة الرضى والقبول	☐	☐	☐	☐	☐

22- هل من الممكن أن تنصح أفراد العائلة والأصدقاء بالتعامل مع المصرف الاسلامي؟

بكل تأكيد	ممكن	ربما	غير ممكن	لايمكن أبدا
☐	☐	☐	☐	☐

23- شكرا جزيلا لك عزيزي المشارك، إذا كانت لديك أية ملاحظات أو تعليق ، يرجى إضافتها هنا
